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In the Supreme Court of the United States

OCTOBER TERM, 1979

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PORTLAND CEMENT COMPANY OF UTAH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (App. A, *infra*, 1a-11a) is unofficially reported at 36 T.C.M. 578. The opinion of the court of appeals (App. B, *infra*, 12a-16a) is reported at 614 F.2d 724.

JURISDICTION

The judgment of the court of appeals was entered on February 5, 1980 (App. C, *infra*, 17a). By order dated April 24, 1980, Mr. Justice White extended the time for filing a petition for a writ of certio-

rari to and including June 4, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Where the depletable "gross income from mining" under Section 613(c)(1) of the Internal Revenue Code of 1954 of an integrated miner-manufacturer of cement must be determined under the "proportionate profits" method, *i.e.*, an allocation of the receipts from the sale of its manufactured product to the mining phase of its operation in the ratio that its mining costs bear to its total (mining plus nonmining) costs:

1. Whether, in determining the amount of income to be allocated in accordance with the costs ratio, the income is to be computed on the assumption that only cement sold in bulk is respondent's first marketable product, as the decision below held, or that both bulk and bagged cement constitute respondent's first marketable product, in accordance with the governing Treasury Regulations.

2. Whether, in determining the ratio of mining to total costs, post-manufacturing costs of bags, bagging, storage, distribution, and sales should be included in the proportionate profits computation as nonmining costs, in accordance with the governing Treasury Regulations.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of Sections 611 and 613 of the Internal Revenue Code of 1954 (26 U.S.C.),

Treasury Regulations 118 (1939 Code), Section 39.23(m), and Treasury Regulations, Sections 1.613-3, 1.613-4, 1.613-5 (26 C.F.R.), are set forth at App. D, *infra*, 18a-43a.

STATEMENT

1. Respondent is a Utah corporation which is an integrated miner-manufacturer of Portland cement. For many years, it has engaged in the quarrying of an argillaceous rock, known as cement rock, and the processing of that rock into finished Portland cement (App. A, *infra*, 2a).

The mining phase of respondent's operations begins with the blasting of the cement rock from the face of the mountainous quarry owned by it. The loose rock is then fed through machinery which reduces the material to a size of less than one square inch. After transportation to a processing plant, the material is ground to a high degree of fineness. During the grinding process, water is added to the powder and a very fine mud, known as "slurry," is formed. The slurry is stored in tanks where it is continuously agitated to maintain a uniform texture. Respondent conducts frequent chemical analyses of the slurry to ensure that it is of a proper composition for making Portland cement (App. A, *infra*, 2a-3a).

During the manufacturing phase of respondent's operations, the liquid slurry is fed into rotary kilns and fired. The heat of the kiln expels moisture from the material and converts carbonates to oxides. As the material is heated to the point of fusion, a

hard glass-like substance, known as a clinker, is formed. The clinker is thereafter cooled and ground with purchased gypsum to produce finished cement. After the final grinding, respondent places its finished cement in storage silos to await sales to customers (App. A, *infra*, 3a-4a).

During the taxable years at issue, respondent sold its finished cement in two ways, either in bulk or in bags. Most of respondent's output was sold in bulk in tank cars, which were loaded directly from the storage silos. A small portion of the output was run from the storage silo into a bin above a bagging machine where it was sealed in paper bags in which it was thereafter sold (App. A, *infra*, 4a).

2. On its federal income tax returns for the taxable years ended March 31, 1970-1972, respondent computed its "gross income from mining" in accordance with the proportionate profits method set forth in Treasury Regulations, Section 1.613-4(d)(4) (26 C.F.R.) (App. D, *infra*, 35a-39a). This method has been prescribed by successive Treasury Regulations since 1940.[1] It allocates the sales price of the integrated miner-manufacturer's first marketable product between the mining and nonmining phases of its operations in the same ratio as the costs of its mining process bear to its total costs.

On its tax returns for the years in question, respondent took the position that bulk cement, and not

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[1] See Treasury Regulations 103 (1939 Code), Section 19.23(m)-1(f); Treasury Regulations 111 (1939 Code), Section 29.23(m)-1; Treasury Regulations 118 (1939 Code), Section 39.23(m)-1(e)(3), App. D, *infra*, 22a-24a.

bulk and bagged cement, constituted its first marketable product. It also excluded from the proportionate profits method formula the costs it incurred for storage, distribution and sales. Respondent reported a greater amount of "gross income from mining" (and thereby claimed a greater depletion base) by applying the proportionate profits computation to the gross sales price of its bulk cement and by excluding the costs of bags, bagging, storage, distribution, and sales from the total costs element of the formula (App. A, *infra*, 6a).

3. On audit, the Commissioner of Internal Revenue determined deficiencies in respondent's tax liabilities on the grounds that: (1) bulk and bagged cement constituted respondent's first marketable product, and (2) the costs of bags, bagging, storage, distribution and sales were includable in the "total costs" element in the formula. The Commissioner's computation yielded a reduced amount of "gross income from mining" and a correspondingly smaller depletion base (App. A, *infra*, 1a-2a, 6a).

Respondent thereafter brought this suit in the Tax Court for redetermination of the deficiencies. The Tax Court upheld respondent's computation and correspondingly larger depletion deduction. Invoking the *Golsen* rule,[2] pursuant to which the Tax Court follows the law of the circuit to which a case would be appealed, the Tax Court ruled that it was bound

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[2] See *Golsen* v. *Commissioner*, 54 T.C. 742 (1970), aff'd on other issues, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971).

by *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), cert. denied, 395 U.S. 936 (1969) (Black and Harlan, JJ., dissenting; White and Marshall, JJ., not participating), rehearing denied, 396 U.S. 975 (1969); and *Portland Cement Co. of Utah* v. *United States*, 412 F.2d 894 (10th Cir. 1969). In so holding, the Tax Court rejected the Commissioner's argument that subsequent changes in the Treasury Regulations explicitly classifying the costs of bags, bagging, storage, distribution, and sales as nonmining costs made the *Golsen* rule inapplicable because the premises underlying the Tenth Circuit's earlier decisions were no longer valid (App. A, *infra*, 8a-11a).

The court of appeals affirmed (App. B, *infra*, 12a-17a), noting that "[w]e can add little, if anything, to the analysis made by the Tax Court" (App. B, *infra*, 13a-14a). In so ruling, it considered dispositive its earlier decision in *Ideal Basic Industries*, that " 'bulk cement' is marketable as such, and under the Regulations it is the 'first marketable product.' The bagged cement is the next stage, and it is, as the Tax Court indicated, the second marketable product" (App. B, *infra*, 14a-15a).

Adhering to the *Ideal Basic Industries* rationale, the court of appeals also rejected the Commissioner's argument that the cement in the bags is the same product as the cement in the bulk silos and his reliance upon Treasury Regulations, Section 1.613-4(d)(4)(iv) (App. D, *infra*, 37a-38a). That Regulation explicitly provides that "bulk and packaged products are considered to be essentially the same

product." As the court saw the matter, "[i]t is obvious that both are 'cement,' but it is equally apparent that it is 'first marketable' as bulk cement, not as bagged cement" (App. B, *infra*, 15a). The court of appeals further agreed with the Tax Court that the changes in the Regulations subsequent to the *Ideal Basic Industries* decision were not significant because they did not alter the definition of "first marketable product" (App. B, *infra*, 15a).

The court of appeals also affirmed the Tax Court's exclusive of respondent's bags, bagging, storage, distribution and sales costs from the "total costs" element in the proportionate profits formula. In support of this aspect of its holding, it adhered to its prior ruling in *Ideal Basic Industries* that "the costs of bagging and of bags were *not* mining costs, and should be excluded under an application of the proportionate costs doctrine" (App. B, *infra*, 15a; emphasis in original). In its view, "[t]hese costs thus had no part there in the determination of the income from the first marketable product. They have no part here when *Ideal Basic* is applied" (*ibid.*).

REASONS FOR GRANTING THE PETITION

The rulings below are variously in conflict with the decisions of the Courts of Appeals for the Third, Fourth and Ninth Circuits and the Court of Claims. The result is confusion and uncertainty in an area of tax law that affects, in the first instance, the numerous members of the integrated Portland cement in-

dustry who are located throughout the country. Potentially affected are all integrated miner-manufacturer industries to the extent that the proportionate profits method is necessarily applied in computing the depletion allowances of their members. This Court should resolve the conflict and establish a national rule so that the tax liabilities of integrated miner-manufacturers can be determined in a uniform manner.

1. In seeking review with respect to these questions, we recognize that the Court denied certiorari 11 years ago in a previous case decided by the court below, *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), cert. denied, 395 U.S. 936 (1969) (Black and Harlan, JJ., dissenting, White and Marshall, JJ., not participating), rehearing denied, 396 U.S. 975 (1969); and that the court of appeals upheld respondent's position on the authority of its earlier ruling in that case. If there were no developments since this Court's prior consideration of the matter, we would be reluctant to petition for certiorari a second time. The circumstances, however, have sufficiently changed to call for review by this Court of what has now apparently become a persistent refusal by the Tenth Circuit to accept the fundamental premises underlying the proportionate profits method.

(a) At the time the Court declined review in *Ideal Basic Industries*, there was an unacknowledged conflict between: (1) the court below and *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (3d Cir. 1966), with respect to the inclu-

sion of bagged cement in gross sales of the first marketable product; and (2) the court below, on the one hand, and *Whitehall Cement* and *Standard Lime & Cement Co.* v. *United States*, 329 F.2d 939 (Ct. Cl. 1964), on the other hand, with respect to the inclusion of post-manufacturing costs in the proportionate profits computation.

However, since the denial of certiorari in *Ideal Basic Industries*, two courts of appeals have explicitly rejected the Tenth Circuit's approach. Thus, in *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 167-172 (1969), the Ninth Circuit held that the costs of bags and bagging cement, and the profits attributable to sale of bagged cement, must be included in the proportionate profits method and that such costs are allocable to the nonmining part of the taxpayer's operations.[3] The court also held that selling expenses must be included in the proportionate profits computation. Moreover, in *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484, 486-487 (1970), the Fourth Circuit held that selling and advertising expenses of an integrated miner-manufacturer must be included in the proportionate profits computation.

There is now a square conflict of decisions on both questions that has been explicitly acknowledged by the

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[3] The Ninth Circuit's decision in *California Portland Cement Co.* was issued on June 4, 1969, two days after this Court denied certiorari in *Ideal Basic Industries*. Although we called the attention of the Court to that decision in a petition for rehearing in *Ideal Basic Industries*, the Court denied rehearing (396 U.S. 975 (1969)) (White and Marshall, JJ., not participating).

Ninth and Fourth Circuits. Indeed, even the court below conceded as much—albeit reluctantly—observing that "[t]he Ninth Circuit has apparently reached a different result—at least as to non-mining costs—in *United States* v. *Calif. Portland Cement Co.*, 413 F.2d 161 (9th Cir.)" (App. B, *infra*, 14a). As long as the court below adheres to its lone position, the proportionate profits method, as established by the Treasury Regulations and approved by the other federal courts, will not be correctly applied in the Tenth Circuit. Thus, an integrated producer having a tax home there may have his constructive mining income and his depletion deduction improperly augmented and thereby enjoy a competitive advantage over similarly-situated taxpayers located outside the Tenth Circuit. Events during the past decade therefore demonstrate that the conflict will persist absent the establishment of a national rule by this Court.

(b) Moreover, since the Court's denial of certiorari in *Ideal Basic Industries*, the administrative importance of the questions presented has substantially increased. In our petition in that case (No. 1279, October Term 1968), we stated (page 17) that there were 22 similar cases presenting proportionate profits issues then being litigated involving more than $6 million in taxes. We are now advised by the Internal Revenue Service that there are currently 24 proportionate profits cases presently pending either in the courts or administratively with approximately $26 million at stake. The problem thus continues to affect a substantial number of tax-

payers with respect to which there has been more than a four-fold increase in the amount of revenue at issue. Since it will be impossible for the Treasury to administer the statute in an even-handed manner until the conflict is resolved, this Court should now settle the confusion and uncertainty that affects both the government and industry alike with respect to these important questions.

2. Section 611(a) of the Internal Revenue Code of 1954 (App. D, *infra*, 18a) authorizes a "reasonable allowance for depletion" of natural deposits "in all cases to be made under regulations prescribed by the Secretary or his delegate." In the case of hard minerals, the allowance is a specified percentage of "gross income from mining." Sections 613(a) and (b) of the 1954 Code (App. D, *infra*, 18a-19a). The rate for calcium carbonate rock, from which cement is made, was 15% for respondent's taxable year ended March 31, 1970, and 14% for its taxable years ended March 31, 1971 and 1972. Section 613 (b)(7) of the 1954 Code (App. D, *infra*, 19a-20a).

If a miner does not conduct manufacturing operations, *i.e.*, if he does not "destroy the physical or chemical identity of the minerals or permit them to be transformed into new products" (*United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86 (1960)), his "gross income from mining" is usually his actual gross receipts from the sales of the raw material. In the case of an integrated producer—one who does not sell the raw material he mines, but uses it in his own manufacturing operations—"gross income from

mining" is the producer's constructive income from the raw mineral product of his mining operations (*ibid.*).

The governing Treasury Regulations (Section 1.613-4(c) and Section 1.613-4(d), App. D, *infra*, 32a-39a) provide two methods for determining the constructive "gross income from mining" of an integrated miner-manufacturer. Under both methods the constructive figure is derived from actual sales data. If a representative price for the raw material is established by arm's-length sales in a relevant market —by the taxpayer or another miner—that price is the measuring-stick of constructive mining income for the raw mineral which the integrated producer uses in his own manufacturing operations. But if such a representative price cannot be established because the raw mineral is not generally sold on the open market—as in the integrated cement industry—then the producer's constructive mining income is derived under the proportionate profits method from his own sales price of his manufactured end product.

The objective of the proportionate profits method is to identify the portion of an integrated producer's gross sales that has been produced by the costs of his mining operations; that portion is the producer's constructive mining income. In substance, the method, long established under the Treasury Regulations, apportions gross sales receipts between mining and nonmining income in the same ratio as the producer's mining costs bear to its overall costs.

The apportionment is reflected in the following equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales of cement} = \text{Gross income from mining}$$

Treasury Regulations, Section 1.613-4(d)(4)(ii) (App. D, *infra*, 37a); *Arvonia-Buckingham Slate Co.* v. *United States*, *supra*, 426 F.2d at 486; *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 167 n.2; *Whitehall Cement Manufacturing Co.* v. *United States*, *supra*, 369 F.2d at 471.

The basic theory of the method is that every dollar of the producer's costs, mining and nonmining alike, is deemed to produce the same proportionate part of the profits earned through sales of the first marketable product; and it is the gross receipts from such sales which are apportioned in accordance with the cost ratio. Treasury Regulations, Section 1.613.4(d)(4)(i) (App. D, *infra*, 35a-36a); *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 168; *Whitehall Cement Manufacturing Co.* v. *United States*, *supra*, 369 F.2d at 471-~~742~~; *United States* v. *Portland Cement Co. of Utah*, 378 F.2d 91, 92 (10th Cir.), cert. denied, 389 U.S. 975 (1967). The premise that every dollar of costs produces the same ratable part of the profits is in accord with long-settled principles of corporate accounting. See Paton and Littleton, *An Introduction to Corporate Accounting Standards* 67 (American Accounting Association 1940).

3. (a) The decision below that respondent's gross sales of cement should be determined on the assump-

tion that all its cement was sold in bulk is in conflict with the decisions of the Ninth Circuit in *California Portland Cement Co.* and the Third Circuit in *Whitehall Cement.* Like the decision below, the taxpayer in *California Portland Cement Co.* argued that its profits resulting from sales of bagged cement should be excluded from the proportionate profits formula on the ground that the first marketable product obtained from the calcium carbonate rock was bulk cement.

But the Ninth Circuit rejected this contention, citing with approval the explicit direction of Treasury Regulations, Section 1.613-3(d)(1)(iv) (App. D, *infra*, 25a) that "bulk and packaged products are considered to be essentially the same product" and that with respect to a cement manufacturer, "the finished cement of various types, *in bulk and bags*, constitutes the first marketable product or group of products produced by him" (emphasis added). In so ruling, the Ninth Circuit observed (413 F.2d at 169) that the treatment of bag and bagging costs by the court below in *Ideal Basic* was not consistent "with other language of that opinion * * *" that states that " 'the sales price of the first marketable product is to be computed on the identical physical material that is represented by total mining and nonmining costs' " (404 F.2d at 125 n.1). Moreover, the Ninth Circuit (413 F.2d at 170) agreed with the conclusion of the dissenting judge in *Ideal Basic* that "[t]o eliminate all post-manufacturing costs destroys consideration of the representative market or field price of the first marketable product, a prime factor

in the application of the equation, and thus seems * * * to reject the method itself" (404 F.2d at 128).[4]

In *Whitehall Cement*, the Third Circuit reached a similar conclusion prior to the 1968 promulgation of the definition of "first marketable product" in the Treasury Regulations.[5] There, the taxpayer likewise argued that the costs incident to and premiums charged for cement sold in bags should be excluded from the proportionate profits calculation, on the theory that the bagging costs were more than the premium so that those costs could not fairly be considered to have produced a proportionate share of the manufacturer's overall profits. The court rejected this argument as resting on (369 F.2d at 474) "an erroneous assumption that the packaging costs produced only the additional revenue derived from the premiums * * *. It seems reasonable to infer that the profits realized from the sale of packaged cement, and these were substantial, were attributable at least in part to the packaging costs." The court therefore

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[4] The decision below also conflicts with *General Portland Cement Co.* v. *United States*, 438 F. Supp. 27 (N.D. Tex. 1977), on appeal to the Fifth Circuit (No. 77-2831). There, the court stated: "To say that the cement in the truck and barge is the first marketable product is to defy the reality of the marketing process. Both large and small orders are sold as cement; the only difference between the two methods of sale is how the customer receives his cement. Different legal results which depend upon the mere size of the order of cement are simply not rational" (438 F. Supp. at 35).

[5] See T.D. 6965, 1968-2 Cum. Bull. 265. The current Regulations were promulgated in 1972 and are substantially the same. T.D. 7170, 1972-1 Cum. Bull. 178. They are retroactively applicable for all years governed by the 1954 Code.

held that the packaging costs must be included in the denominator of the proportionate profits equation as nonmining costs and that the profits attributable to such costs should be included in gross sales (*ibid.*).

(b) There is no basis for the theory upon which the decision below rests that cement in bulk is the first marketable product so that the bulk price should be the assumed price for all sales of cement. To begin with, that ruling cannot be squared with the Treasury Regulations defining first marketable product in the context of the cement industry that were issued pursuant to an express congressional authorization (Section 611(a)) to deal with "the multifarious circumstances which would involve questions of depletion" *Douglas* v. *Commissioner*, 322 U.S. 275, 281 (1944). As the Court has long recognized, such legislative Regulations are entitled to the same deference as the Code itself unless deemed to be arbitrary or contrary to the statutory authorization. *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501 (1948).

But wholly apart from the explicit command of the Regulations that we submit should govern here, the conclusion that cement in bulk is a qualitatively different product from cement sold in bags and is therefore respondent's first marketable product materially distorts the application of the proportionate profits method. Under that method, the nature of the first marketable product depends upon its physical and chemical characteristics. See *United States* v. *Cannelton Sewer Pipe Co.*, *supra*, 364 U.S. at 85-86. Neither the quantities nor the packages in which it

is sold, and which determine the per unit price, affect the nature of the product. Bulk cement and cement sold in bags is unquestionably the same product. The container for that product—whether it be a tank car supplied by the customer or a bag supplied by respondent—does not alter the physical and chemical characteristics of the cement. The proportionate profits method requires an allocation of the actual gross receipts received upon the sale of that product, and that must be determined, as it was in the Ninth and Third Circuits, solely on the basis of the prices in fact charged for the commodity regardless of variations depending upon such things as packaging. To exclude from gross sales any part of the sales proceeds of any cement will not yield the correct amount of gross income from mining under the proportionate profits formula upon which the statute allows percentage depletion.

4. The decision below to exclude post-manufacturing costs of bags, bagging, storage, distribution and sales from the proportionate profits computation is in conflict with the Ninth Circuit's decisions in *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 167-172 (costs of bags, bagging, and sales) and *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508-510 (1970) (costs of shipping, bags, bagging and selling); the Fourth Circuit's decision in *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484 (1970) (costs of advertising and sales); the Third Circuit's decision in *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (1966) (costs of bags, bagging, and bulk load-

ing); and the Court of Claims' decision in *Standard Lime & Cement Co.* v. *United States*, 329 F.2d 939 (1964) (costs of containers, packing, loading and storing).[6] These courts have held that these post-manufacturing costs were incurred to sell the first marketable product, that a proportionate part of the profits from the sale of the first marketable product is allocable to these costs, and that they should be included in the proportionate profits formula.[7]

There is no dispute that the costs of storing, shipping, bagging and bags are nonmining costs. The Treasury Regulations (Sections 1.613-4(d)(3)(i) and (iii), 1.613-4(g)(3) and (4), App. D, *infra*, 33a-35a, 42a-43a) so provide; and the court below as well as the other courts have so held. With respect to selling expenses, the Treasury Regulations

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[6] The decision below also conflicts with the following district court decisions: *General Portland Cement Co.* v. *United States*, 438 F. Supp. 27 (1977) (costs of bags, bagging, loading and storing); and *Mississippi Valley Portland Cement Co.* v. *United States*, 347 F. Supp. 240 (S. D. Miss. 1972) (costs of shipping, selling, marketing, and packaging).

[7] In *Standard Lime & Cement Co.* v. *United States*, 329 F.2d 939 (1964), the Court of Claims employed a computational approach different from the ratio formula set forth in the current Regulations and adopted by other courts under Treasury Regulations 118. This approach achieves the same end result, however, because the same basic theory was applied. *Standard Lime* reflects the literal description of the proportionate profits method in the 1939 Code Regulations. Under that description, post-manufacturing costs, together with their proportion of the profits, are subtracted from gross sales. This manner of working back from gross sales maintains the proper correspondence between a constructive income figure and related costs at any point in an integrated producer's operations.

(Section 1.613-4(d)(3)(iv) and 1.613-5(c)(4)(ii), App. D, *infra*, 35a-43a) provide that they are nonmining costs except when a taxpayer shows that an unintegrated miner or producer typically incurs selling expenses, in which case such expenses are allocated between mining and nonmining costs. Respondent, however, made no such showing in this case. Accordingly, the courts below correctly held them to be nonmining costs. The only question is whether these nonmining costs are included as such in the proportionate profits computation.

Contrary to the decision below, the Regulations and the cases including these costs in the formula are correct. No expenses may be eliminated from the proportionate profits method, for the underlying accounting theory is abrogated unless a producer's gross sales are allocated in accordance with a cost fraction which includes in its denominator *all* of the costs producing the sales. The determination of the integrated miner-manufacturer's "gross income from mining" requires an allocation of all its income from sales of the first marketable product between the mining and nonmining phases of the company's operations. All costs and all of the profit must be allocated to either the mining or the nonmining part of the operation. If an item of expense in fact results from the mining phase of the business, it should be included in the "gross income from mining," and also carry into "gross income from mining" its ratable share of the company's profit or loss. By the same token, every cost that is attributable to the non-

mining operations, together with its allocable share of profit or loss, must be excluded from the depletion base. Otherwise the proportionate profits formula will be distorted with the result that the depletion allowance will not be restricted to its intended ambit, the return of the miner's capital interest in depletable materials. *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 172.

Here, as in its previous decision in *Ideal Basic Industries*, the court below refused to recognize that all of the costs of producing and selling cement had to be taken into account in determining the costs ratio. It correctly reaffirmed its prior holding that "the costs of bagging and of bags were *not* mining costs * * *" (App. B, *infra*, 15a). But it erroneously refused to apply the basic theory of the proportionate profits method to these costs, in holding that they "should be excluded under an application of the proportionate costs doctrine" (*ibid.*).

By excluding these costs from the denominator (total costs) of the costs fraction, the decision below has in effect put part of the post-manufacturing costs and their allocable share of profits within respondent's depletion base. This distortion is a consequence of the court's requiring the allocation of sales income (erroneously limited to bulk cement) by a ratio that includes only mining and manufacturing costs in the denominator. As the dissenting judge observed in *Ideal Basic Industries*, in terms that are equally appropriate here, this decision "reaches a result that is a rejection of the basic theory of the

proportionate profit method itself" (404 F.2d at 127). The court of appeals' persistent rejection of this well-established method of computing the depletion deduction should not be permitted to stand.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

WADE H. MCCREE, JR.
Solicitor General

M. CARR FERGUSON
Assistant Attorney General

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JUNE 1980

APPENDIX A

T. C. Memo. 1977-137

UNITED STATES TAX COURT

Docket No. 6306-73

Filed May 9, 1977

PORTLAND CEMENT CO. OF UTAH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Glen E. Fuller and *Jack R. Decker*, for the petitioner.

S. Clay Freed, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge*: Respondent determined deficiencies in petitioner's Federal income tax as follows:

FYE	Deficiency
March 31, 1970	$44,200
March 31, 1971	41,509
March 31, 1972	7,175

The deficiencies pertain to petitioner's method of computing percentage depletion under section 613.[1]

[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

Specifically, we are to decide whether petitioner has made a proper application of the proportionate profits method of determining gross income from mining.

FINDINGS OF FACT

Petitioner is a Utah corporation which maintained its principal place of business at Salt Lake City, Utah, when the petition herein was filed. For each of the years in issue it filed a corporate income tax return with the Western Service Center, Ogden, Utah.

Petitioner is an integrated miner-manufacturer of Portland cement. It has for many years engaged in the quarrying of an argillaceous limestone rock,[2] known in the trade as cement rock, and in the processing of that rock into finished Portland cement.

The manufacture of Portland cement begins with the mining of cement rock. Petitioner obtains cement rock from its own quarry located 12 miles from its Salt Lake City processing plant. The cement rock is first blasted free of the mountainous quarry face, then pushed by bulldozer to the quarry floor. Secondary blasting is employed, if necessary, to further reduce the size of large boulders. The loose rock is then transported to "reduction" machinery where it passes through a jaw crusher and an impacter which further reduce the material to a size of less than one inch. The crushed material is

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[2] Referred to as "calcium carbonates" or "limestone" in sec. 613(b)(7), I.R.C. 1954.

stored temporarily at the quarry in bins awaiting loading into trucks for transportation to the processing plant.

Arriving at the processing plant, the material is unloaded and placed in open stockpiles. The material is then fed into rod-ball mills which grind the rock to a fineness so that 75 percent volume passes through a 200 mesh sieve. During this grinding process, water is added to the powder and a "slurry," a very fine mud, is formed. The slurry is stored in tanks where it is continually agitated to maintain a uniform mixture. The mining phase of the operation concludes at this point.

During the manufacturing phase, the liquid slurry is fed into rotary kilns and burned. The heat of the kiln expells moisture from the material and converts carbonates to oxides. As the material is heated to a point of incipient fusion, complex silicates and aluminates are formed by chemical reactions occurring inside the kiln. The result of the burning process is a hard, glass-like "clinker." The clinker is cooled and later ground with purchased gypsum to produce finished cement.

The rock in taxpayer's quarry varies in chemical composition. Certain areas within the quarry do not contain all the ingredients necessary to produce finished Portland cement. When rock is quarried from these areas it becomes necessary to add to the cement rock supplementary chemical materials. The various chemical supplements are added to the cement rock during the grinding phase in the rod-ball

mill. High lime rock is added to correct any calcium carbonate deficiency in the quarried rock; iron slag is added to correct any iron deficiency; silica is added to compensate for lacking silica oxides.

If the required amounts of calcium carbonates, iron and silica oxides are not present in the slurry as it is introduced into the kiln, chemical actions required to produce a clinker from which Portland cement can be made will not occur. It is only when the proper proportions of materials are introduced into the rod-ball mill that the necessary chemical reactions will take place during the burning in the kilns. Frequent chemical analyses are made by petitioner's chemists to ensure that the slurry is of a proper composition for making Portland cement.

After final grinding, finished cement is placed in storage silos to await sales to customers. Petitioner's finished cement is sold in two ways. Most of petitioner's output is sold in bulk in tank cars, loading directly from the storage silos. A small portion of the output is run from the storage silo into a bin above a bagging machine where it is sealed in paper bags and thereafter sold in that form.[3]

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[3] The parties have agreed upon the amounts of most of the expenses that are required in computing petitioner's depletion deduction. Since this controversy involves the application of the depletion computation, a recital of these amounts would not furnish an aid to an understanding of this case. Accordingly, they are not set forth in our findings of fact.

OPINION

In computing the amount of its gross income from mining, a component necessary to arriving at its percentage depletion allowance for the years in issue, petitioner utilized the proportionate profits method of computation. See sec. 613.

According to the regulations:

> The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales * * * of his *first marketable product* or group of products * * * by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the *first marketable product* or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the *first marketable product* or group of products * * *. The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, § 39.23(m)-1(e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:
>
> $$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining.}$$
>
> [Sec. 1.613-4(d)4(ii), Income Tax Regs.; emphasis supplied.] [4]

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[4] The depletion regulations are legislative in nature, having the force and effect of law. Sec. 611(a).

The controversy in this matter centers on the costs which constitute "total costs" in the above formula. The resolution of this question depends in turn upon the meaning of the term "first marketable product" as stated in the regulation.

Petitioner sells finished cement both in bulk and in bags. Since the difference between the bulk and bagged price does not exceed the cost of the bags and bagging, petitioner would have a greater depletion base if the proportionate profits computation were applied to the value of its bulk cement, and the bags and bagging costs entirely excluded from the formula.

On its Federal income tax returns for the years in issue, petitioner took the position that bulk cement, rather than cement in bags, constituted its first marketable product, and applied the formula accordingly in computing its depletion deduction. Respondent, on the other hand, would have us include the costs of bags and bagging in the "total costs" portion of the formula, thereby decreasing the ultimate amount of "gross income from mining" and the corresponding depletion deduction. Additionally, respondent would further include in the formula the costs incurred in selling, shipping, and storing, along with the indirect costs attributable to these activities.

The taxpayer in this case maintains its principal place of business in Salt Lake City, Utah, and, therefore, an appeal of the decision herein would lie in the Tenth Circuit. The Court of Appeals for the

Tenth Circuit previously considered this issue in *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968).[5]

In that case the court held bulk cement to be the first marketable product, stating at pages 125-126:

> We conclude that "first marketable product" is the proper sales price to which the application of the formula was intended, therefore, the costs of bags, bagging, and bulk loading should be eliminated from all parts in the formula. "Consequently we must hold that those packing and loading costs are indirect costs which are not incurred for the benefit of the entire operation and as such *cannot be included in taxpayer's computation of gross income* from the property at kiln feed." Standard Lime & Cement Co. v. United States, 329 F.2d 939, 948, 165 Ct. Cl. 180 (1964) (emphasis added); accord, United Salt Corp., 40 T.C. 359 (1963). Equally compelling is the simple logic that bulk cement is the first marketable product,[2] bagged cement is the second marketable product, as for example "sakrete"[3] would be a third marketable product.

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[2] Bulk cement is the first marketable product because it *can* be sold. * * *

[3] "Sakrete" is a bagged mixture of cement, sand, and gravel to which water may be added to make concrete.

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[5] See also *Portland Cement Company of Utah* v. *United States*, 412 F.2d 894 (10th Cir. 1969), in which the Tenth Circuit followed *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), in a subsequent case involving the petitioner herein on the identical issue.

In the present case petitioner contends simply that we are bound by this holding pursuant to the rule set forth in *Golsen* v. *Commissioner*, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971).

Respondent, relying on the holdings in *Commissioner* v. *Sunnen*, 333 U.S. 591 (1948), and *CBN Corporation* v. *United States*, 364 F.2d 393 (Ct. Cl. 1966), cert. denied 386 U.S. 981 (1967), contends that certain amendments to the pertinent regulations adopted subsequent to the Tenth Circuit's decision in *Ideal Basic* have worked a change in the legal atmosphere sufficient to cause the Tenth Circuit to reexamine their previously expressed position. As such, he argues, the Tenth Circuit's position insofar as we are concerned is no longer a foregone conclusion and the *Golsen* rule is therefore inapplicable in this instance.

Thus, at this point, it becomes our task to determine the extent, if any, by which the regulation changes have affected the definition of the term "first marketable product."

In 1972 the sections of the regulations dealing with the proportionate profits method of computation were revamped. At that time the main definitional portions of the regulations describing the proportionate profits method were carried over intact. Several new portions, however, were added.

In support of his position herein, respondent relies principally on the following language, added subse-

quent to the *Ideal Basic* decision, contained in section 1.613-4(d)(3)(iii)(a), Income Tax Regs.:

> (iii) In determining gross income from mining by use of methods based on the taxpayer's costs—
>
> > (a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

Since this addition specifically states that the costs of bags and bagging are to be treated as nonmining costs, respondent concludes that such costs are now necessarily includable in the formula as an element of "total costs" rather than being eliminated entirely as the Tenth Circuit directed in *Ideal Basic*.

Respondent's view, however, overlooks a pivotal consideration. Notwithstanding the new regulation's specific mention of bags and bagging costs, such additional language does not purport to alter the definition of the makeup of the elements which constitute the first marketable product.[6] Rather, such change merely clarifies the classification among certain costs which are common to almost all integrated mining-manufacturing operations.[7]

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[6] Sec. 1.613-4(d)4(iv), which defines the term "first marketable product," was transferred completely intact from the old to the new regulatory material.

[7] Indeed, the Tenth Circuit takes no issue with the view that the cost of bags and bagging constitutes *nonmining* expenses. See *Ideal Basic Industries, supra* at 125.

Thus, once bulk cement is determined to be the first marketable product, the costs of bags and bagging become an element of producing a second marketable product—bagged cement; hence, these costs are of no consequence in determining gross income from the sale of the first marketable product. Given the fact that in the Tenth Circuit's view, bulk cement—the first marketable product—is produced before the bagging process commences, the amended regulation's mere reference to such bagging costs does not support respondent's claim for mandatory inclusion in the formula.

With regard to storing, shipping, and selling costs involved in the present case, the result is the same. As further stated in *Ideal Basic*:

> The advertising, promotional, and selling costs are not a proper part of the computation. These costs, like bagging (packing) and loading costs are overhead charges properly applicable to finished cement after it has become "first marketable product." * * *

Similarly, the court directed that the costs of operating storage warehouses and distribution terminals and the transportation en route be eliminated from the formula. 404 F.2d at 126.

We conclude that the issue herein was fully aired and decided by the Tenth Circuit in *Ideal Basic, supra.*[8] The premise underlying that decision re-

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[8] This case marks petitioner's sixth round in depletion-related litigation. See *Portland Cement Company of Utah* v.

mained unaffected by the regulation change. We are therefore bound to follow that decision in accordance with the requirements of *Golsen* v. *Commissioner, supra.*

To reflect the foregoing conclusions,

Decision will be entered under Rule 155.

United States, 412 F.2d 894 (10th Cir. 1969); *United States* v. *Portland Cement Company of Utah,* 378 F.2d 91 (10th Cir. 1967); 338 F.2d 798 (10th Cir. 1964); 315 F.2d 169 (10th Cir. 1963); 293 F.2d 826 (10th Cir. 1961).

APPENDIX B

PUBLISH

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 78-1290

PORTLAND CEMENT COMPANY OF UTAH,
a corporation, APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLANT

On Appeal From The Decision Of The
United States Tax Court

[Filed Feb. 5, 1980]

David English Carmack, Department of Justice, Washington, D.C. (M. Carr Ferguson, Assistant Attorney General, Gilbert E. Andrews and Grant W. Wiprud, attorneys, Tax Division, Department of Justice, Washington, D.C., with him on the brief), for Appellant.

Glen E. Fuller, Salt Lake City, Utah, for Appellee.

Before SETH, Chief Judge, MCKAY and LOGAN, Circuit Judges.

PER CURIAM.

This is another chapter in the litigation concerning the application of the depletion allowance to the mining of cement rock and the manufacture of cement. The appellee in its brief states that this is its sixth appearance in this court on the issue. The fifth was in Portland Cement Co. of Utah v. United States, 412 F.2d 894 (10th Cir.). We also handed down an opinion in United States v. Ideal Basic Industries, Inc., 404 F.2d 122 (10th Cir.), under the 1968 Regulations. The issue before us is essentially the same as in the two cases cited.

This appeal is from the decision of the Tax Court entered in Docket No. 6306-73 as T.C. Memo 1977-137, 36 T.C.M. 578. This decision held that since the case arose in this circuit, it would be controlled by United States v. Ideal Basic Industries, Inc., 404 F.2d 122 (10th Cir.). The Tax Court held that the changes in the Treasury Regulations in 1972 (§ 1.613-4(d)(4)) would not bring about a change in the result reached in *Ideal Basic*. It determined that the basic consideration was that of the "first marketable product." It noted that the 1972 Regulations carried over the same provisions as were relied on in *Ideal Basic Industries* in the 1968 Regulations. We can add little, if anything, to the analysis

made by the Tax Court, and we agree with the conclusion reached. The Government here seeks to have another review of the *Ideal Basic* case, and of the previous case concerning this same appellee. The Ninth Circuit has apparently reached a different result—at least as to non-mining costs—in United States v. Calif. Portland Cement Co., 413 F.2d 161 (9th Cir.).

As the Tax Court indicated, the "pivotal consideration" is the determination under the Regulations of what is the "first marketable product." We expressly held in *Ideal Basic* that this product was "bulk cement." In the process followed by appellee, when the firing of the slurry in the kilns is complete, a clinker remains. This is then finely ground, and the product is finished cement. This goes into storage silos and is "bulk cement." It is loaded from these silos directly into tank cars and so sold in bulk to customers. Over 90% of appellee's sales are made in this manner. Some of the bulk cement is moved from the storage silos to a bin which is part of a bagging machine which in turn puts the cement into paper bags and seals the bags. The bagged cement is then sold as such to smaller users. The Government seeks to have "bagged cement" be the "first marketable product," and to so include the expenses associated with the bagging. This increase in expenses under the formula would reduce the depletion deduction.

As was held in our previous opinions, "bulk cement" is marketable as such, and under the Regulations it is the "first marketable product." The bagged cement

is the next stage, and it is, as the Tax Court indicated, the second marketable product.

The Government in its argument ignores the "first marketable" aspect of the Regulation, and would move to the second process—the bagging—because the cement in the bags is the same as in the bulk silos. It is obvious that both are "cement," but it is equally apparent that it is "first marketable" as bulk cement, not as bagged cement.

The Treasury Regulations were not changed since *Ideal Basic* as to the definition of "first marketable product." This portion of the old Regulations was carried over intact into the 1972 Regulations as § 1.613-4(d)(4)(iv). These provisions were the basis for the *Ideal Basic* decision, and no reason for a change has been presented.

The 1972 Regulations *added* § 1.613-4(d)(3)(iii)(a) relating to integrated mining activities in general. This provided that costs attributable to bagging, palletizing, etc., "shall be considered as nonmining costs." In *Ideal Basic*, we expressly held that the costs of bagging and of bags were *not* mining costs, and should be excluded under an application of the proportionate costs doctrine. These costs thus had no part there in the determination of the income from the first marketable product. They have no part here when *Ideal Basic* is applied.

The appellee expresses an unhappiness with the proportionate profits doctrine applied in *Ideal Basic* from the Treasury Regulations. It is, as therein described, artificial, but a device necessary for practical

administration. It is obviously unrealistic in some particular instances. As this appeal has developed, we will not consider it as an issue to be reviewed again.

AFFIRMED.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

January Term—February 5, 1980

Before The Honorable Oliver Seth, Chief Circuit Judge, The Honorable Monroe G. McKay, Circuit Judge, and The Honorable James K. Logan, Circuit Judge

PORTLAND CEMENT COMPANY OF UTAH, a corporation, PETITIONER-APPELLEE

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

JUDGMENT

No. 78-1290

This cause came on to be heard on the record on appeal from the United States Tax Court, and was argued by counsel.

Upon consideration whereof, it is ordered that the judgment of that court is affirmed.

/s/ Howard K. Phillips
HOWARD K. PHILLIPS
Clerk

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * * *

SEC. 613. PERCENTAGE DEPLETION.

(a) [as amended by Section 13(e), Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960] *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property

excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of a preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*— * * *

* * * * *

(7) [as amended by Section 302(a), Public Debt and Tax Rate Extension Act of 1960, Pub. L. No. 86-564, 74 Stat. 290; Section 6(a), Act of September 2, 1964, Pub. L. No. 88-571, 78 Stat. 857; Sections 208(a) and 209(a), Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539. In effect for tax years beginning on or prior to October 9, 1969.] 15 percent—[a]ll other minerals (including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magne-

site, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(C) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water, or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

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(7) [as amended by Section 501(a), Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487; Section 501(b)(2), Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26. In effect for tax years beginning after October 9, 1969.] 14 percent—[a]ll other minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk

shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(C) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

(c) [as amended by Section 302(b)(1) and (2), Public Debt and Tax Rate Extension Act of 1960, *supra*] *Definition of Gross Income From Property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.*—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * *

(4) *Treatment processes considered as mining.*—* * *

* * * * *

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln food into the kiln, but not including any subsequent process;

* * * * *

Treasury Regulations 118 (1939 Code):

§ 39.23(m)-1 *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*

* * * * *

(e) As used in sections 114(b)(3) and 114 (b)(4)(A) and §§ 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

* * * * *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the prop-

erty, then such gross income shall be computed by the use of such other method.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.613-3. *Gross income from the property.*

* * * * *

(d) *Sales after the application of nonmining processes where a representative market of field price cannot be ascertained*—(1) *Computation of gross income from the property by use of the proportionate profits method.*

* * * * *

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall be properly apportioned to mining and to nonmining. In the absence of any specific provision of this section providing an apportionment method, such costs shall be apportioned by use of a method which is reasonable in the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which would normally be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes.

On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c) of § 1.613-4.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. The first marketable product or group of products does not include a product or group of products additionally refined, beneficiated, altered, or manufactured as a result of the application of additional nonmining processes. For example, if a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additivies, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially

glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) As used in this paragraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations. The prices at which actual or constructive sales are made are to be determined in accordance with the principles set forth in this paragraph and in paragraphs (b), (c), and (e) of this section, as appropriate. In the case of constructive sales of the taxpayer's first marketable product or group of products, the taxpayer shall attach to his return a statement indicating the price or prices used by him in computing the representative market or field price for such product or products, and the source of his information as to such price or prices. The prices at which actual or constructive sales are made shall not be determined by reference to prices established in transactions between members of a controlled group. See paragraph (a) of § 1.482-1 for the definitions of the terms "controlled" and "group".

* * * * *

(4) *Treatment of particular items in computing gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from

the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relat-

ing to purchased transportation to the customer, and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which the district director determines will clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. Where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to such plants or mills in excess of 50 miles (or of such greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to such excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

* * * * *

(iii) In determining gross income from the property by use of the proportionate profits method (or any other approved method which is based on the taxpayer's costs)—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as

the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from the property by means of the proportionate profits method or any other approved method based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-4 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

* * * * *

(e) *Reductions of sales price in computing gross income from the property*— * * *

* * * * *

(2) *Purchased transportation to the customer.* * * *

* * * * *

(ii) In the case of a taxpayer computing gross income from mining under the provisions of paragraph (d)(1) of this section, the cost of purchased transportation to the customer (as de-

fined in subdivision (iii) of this subparagraph) shall be excluded from the taxpayer's gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph) and from the denominator of the proportionate profits fraction, without attributing profits to the cost of such transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of methods of computation which are approved under paragraph (d)(2) of this section and which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which does not meet the requirements of subdivision (iii) of this subparagraph. See paragraph (d)(4)(i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation from the taxpayer's mine or plant to the customer—

(a) Which is performed in conveyances owned or leased by persons other than the taxpayer, rather than in conveyances owned or leased by the taxpayer;

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling); and

(c) Which is charged to the customer in such a way that the taxpayer ordinarily does not earn any profit with respect to such transportation.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (a)(3) of § 1.482-1) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. The taxpayer must demonstrate the nonprofit character of the transportation services, as described in (c) of this subdivision, in light of all the facts and circumstances. It shall be presumed that the requirements set forth in either (a) or (c) of this subdivision (relating, respectively, to conveyance ownership and profits) are not satisfied if the taxpayer requires customers to purchase minerals or mineral products only on a delivered basis, by failing to offer such minerals or products for sale on the basis of a price f.o.b. the taxpayer's mine or plant, or by other means. In the case of taxpayers computing gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms with the other requirements of this subdivision and which is performed to

transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(1)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

* * * * *

(g) *Nonmining processes*—* * *

* * * * *

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

* * * * *

§ 1.613-4 *Gross income from the property in the case of minerals other than oil and gas.*

* * * * *

(d) *Cases where a representative market or field price cannot be ascertained*—* * *

* * * * *

(3) *Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced there-

from, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding

sentence shall apply only to taxable years beginning after November 30, 1968.

* * * * *

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

* * * * *

(4) *Proportionate profits method.* (i) The objective of the "proportionate profits method"

of computation is to ascertain gross income from mining by applying the principle that each dollar of the total costs paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single taxpayer. See paragraph (j) of this section for the definitions of the terms "controlled" and "group."

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, section 39.23(m)-1 (e)(3) (1939 Code). The pro-

portionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining.}$$

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c)(4) of § 1.613-5.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result

of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing areas. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) (a) As used in this subparagraph, the term "gross sales (actual or constructive)"

means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See (b) of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A "constructive sale" occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(b) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for rules relating to information to be furnished by the taxpayer.

* * * * *

(e) *Reductions of sales price in computing gross income from mining*—* * *

* * * * *

(2) *Purchased transportation to the customer.* * * *

* * * * *

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d)(3)(i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer—

(a) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer.

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the

customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidential storage or handling), and

(c) With respect to which the taxpayer ordinarily does not earn any profit.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (j)(1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transportation constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term "purchased

transportation to the customer" refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(4)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

* * * * *

(g) *Nonmining processes*—* * *

* * * * *

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

(4) *Manufacturing, etc.* The production, packaging, distribution, and marketing of manu-

factured products, and the processes necessary or incidental thereto, are nonmining processes.

* * * * *

§ 1.613-5 *Taxable income from the property.*

* * * * *

(c) *Treatment of particular items in computing taxable income from the property.* * * *

* * * * *

(4) * * *

* * * * *

(ii) A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

* * * * *

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No. 79-1907

In the Supreme Court of the United States

OCTOBER TERM, 1980

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PORTLAND CEMENT COMPANY OF UTAH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

JOINT APPENDIX

Petition for Writ of Certiorari Filed June 3, 1980
Certiorari Granted October 6, 1980

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UNITED STATES TAX COURT
GENERAL DOCKET

DOCKET NO. 6306-73

PORTLAND CEMENT COMPANY OF UTAH, a corporation
(Edwin S. Gallacher, President)
615 West 8th South Street, P.O. Box 1469
Salt Lake City, Utah, 84110 PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

APPEARANCES FOR PETITIONER:
Glen E. Fuller, 15 East 4th South Street,
Salt Lake City, Utah, 84111
Jack R. Decker, 15 East 4th S. St.,
Salt Lake City, Utah, (E/A, 1-20-75)

Date	*Filings and Proceedings*	*Action*	*Served*
Aug. 20, 1973	PETITION FILED: FEE PAID August 20, 1973		Aug. 21, 1973
Aug. 20, 1973	REQUEST by petr. for trial at Salt Lake City, Utah filed	GRANTED Aug. 21, 1973	Aug. 21, 1973
Sept. 13, 1973	ANSWER by Resp. filed.		Sept. 17, 1973
Oct. 17, 1974	NOTICE OF TRIAL on Jan. 20, 1975 at Salt Lake City, Utah.		Oct. 17, 1974
Jan. 20, 1975	TRIAL at Salt Lake City, Utah before Judge Fay.		
	ENTRY OF APPEARANCE by J. R. Decker as counsel for Petr. filed, Jan. 20, 1975.		FEB 21 1975
	STIPULATION OF FACTS and Exhibits, filed.		
	ORIGINAL BRIEFS DUE: March 20, 1975		
	REPLY BRIEFS DUE: April 21, 1975		
	SUBMITTED TO JUDGE FAY		
Feb. 4, 1975	TRANSCRIPT of Jan. 20, 1975 received.		

Date	*Filings and Proceedings*	*Action*	*Served*
Mar. 20, 1975	BRIEF for Resp., filed.		MAR 24 1975
Mar. 20, 1975	BRIEF for Petr. filed.		MAR 24 1975
April 18, 1975	REPLY BRIEF for Petr. filed.		APR 22 1975
April 21, 1975	REPLY BRIEF for Resp. filed.		APR 22 1975
May 9, 1977	MEMORANDUM FINDINGS OF FACT AND OPINION filed, Judge Fay. (Decision will be entered under Rule 155.)		May 9, 1977
June 8, 1977	MOTION by Resp. for Reconsideration of Findings and Opinion filed May 9, 1977. (Exhibit Attached)	MOOT See Order Nov 21, 1977	
June 9, 1977	ORDER, that counsel for Petr. shall have to July 15, 1977 to file any objection to Resp's. motion filed June 8, 1977.		JUN 10 1977
Jul 1, 1977	OBJECTION by Petr. to Resp's. motion for reconsideration of findings and opinion filed.		
Sep 16, 1977	JOINT MOTION to Reopen the Record. (Supplemental Stipulations of Fact Lodged)	GRANTED Sep 23, 1977	SEP 28 1977
Sep 23, 1977	SUPPLEMENTAL STIPULATIONS OF FACT filed.		
Nov 11, 1977	AGREED COMPUTATION filed.		
Nov 21, 1977	ORDER, that resp's. motion for reconsideration of findings and opinion filed Jun 8, 1977 is rendered moot.		NOV 22 1977
Nov 22 1977	DECISION ENTERED, Judge Fay.		Nov 22, 1977
	APPELLATE PROCEEDINGS		
Feb. 17 1978	NOTICE OF APPEAL to U.S.C.A., Tenth Circuit, filed by Resp.		Feb. 21, 1978
Feb. 21, 1978	NOTICE of Filing with copy of notice of appeal mailed to Mr. Glen E. Fuller, counsel for petr.		Feb. 21, 1978
Feb. 21, 1978	NOTICE to parties of assembling and date for transmission of the record.		Feb. 21, 1978

Date	*Filings and Proceedings*	*Action*	*Served*
Feb. 21, 1978	CERTIFIED copy of notice of appeal mailed to U.S.C.A. Court of Appeals for the Tenth Circuit.		
Mar. 15, 1978	MOTION to extend the time for transmission of the record to May 18, 1978, filed by Resp. with "No Obj." by Petr.	GRANTED 3/15/78	Mar. 16, 1978
Mar. 16, 1978	NOTICE, to parties, of assembling and extension of date for transmission of record.		Mar. 16, 1978

GENERAL DOCKET
UNITED STATES COURT OF APPEALS
FOR THE
TENTH CIRCUIT

CASE NO. 78-1290

CIVIL B
APPEAL FORM THE UNITED STATES TAX COURT

TITLE OF CASE

PORTLAND CEMENT COMPANY OF UTAH, a corporation, Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant

GENERAL DOCKET
UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

CASE NO. 78-1290

Portland Cement Company of Utah v. Commissioner of Internal Revenue

Date	*Filings—Proceedings*	*Filed*
4/17/78	Cause docketed; docketing statement—0 & 9 cc, c/s.	
4/26/78	Appearance—appellee—Glen E. Fuller	
*4/27/78	Appearance—appellant—Stuart E. Seigel	
5/15/78	Record on appeal—Volume I (pleadings) (109pp), Volume II (transcript) (63pp), Exhibits (in manila envelope)—Orig. (172++pp)	
5/16/78	Order—assigned to Calendar B; appellant's brief due 6/6/78—Seth	
*5/6/78	Appearance—appellant—M. Carr Ferguson, Gilbert E. Andrews	
6/5/78	Appellant's mot for ext to 7/6/78 to file brief, Order—appellant GRANTED to 7/6/78 to file brief—RLH—cnsl notf'd	
7/10/78	Appellant's brief, 0 & 9 cc, c/s Appearance—Appellant, Wiprud, Carmack	
7/27/78	Appellee's brief, orig. & 9 cc., c/s	
10/18/79	HRG.SET Hearing set for November, 1979, Term—Denver, Colorado	
11/30/79	CS.ARG.SUBM—case argued and submitted to Seth, McKay, Logan	
2/5/80	PC.OPN.F. Per curiam opinion filed—Seth, McKay, Logan (Published) JM. DISP. Judgment affirmed.	
2/27/80	MDT.ISS—mandate issued to District Court	

Date	*Filings—Proceedings*	*Filed*
2/29/80	ROA.RMK. Letter re record to Judge Seth	
2/6/80	ROA.RTN.DC. Record on appeal returned to Dist Ct. Vol. I-II and Brown envelope of exhibits	
3/14/80	ROA.RCPT.F. Record receipt filed.	

[Postmeter stamp 8/15/73]

THE TAX COURT OF THE UNITED STATES

DOCKET NO. 6306-73

[Filed August 20, 1973]

PORTLAND CEMENT COMPANY OF UTAH, a corporation, Petitioner,

vs

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (Correspondence Symbols L—21, Code 411) dated May 23, 1973, and as a basis of its proceedings alleges as follows:

1. The petitioner is a Utah corporation and has its business address at 615 West 8th South Street, P.O. Box 1469, Salt Lake City, Utah. The returns for the periods here involved were filed with the Internal Revenue Service Center for the Western Region, Ogden, Utah.

II. The notice of deficiency (a copy of which is attached hereto and marked Exhibit A), was mailed to petitioner on May 23, 1973.

III. The deficiency as determined by the Commissioner involves income taxes for the fiscal year ended March 31, 1970, in the amount of $44,200.00; and for the fiscal year ended March 31, 1971, in the amount of $41,509.00; and for the fiscal year ended March 31, 1972, in the amount of $7,175.00. The foregoing amount to a total deficiency for the three years involved of $92,884.00, of which the entire amount of the deficiency for each fiscal year is in dispute.

IV. The determination of tax deficiencies set forth in the said notice of deficiency is based upon the following errors:

(a) In applying the "proportionate profits" formula, the Commissioner, although excluding costs of shipping, storage, bagging and related activities in arriving at an amount attributable to the "first marketable product" (i.e. bulk cement), has failed to follow the mandate of the Tenth Circuit Court of Appeals decisions in the cases of *U.S. v. Ideal Basic Industries, Inc.*, 404 F.2d 122, 22 A.F.T.R. 2d 5438, (Cert. Den.) 395 U.S. 936, 89 S. Ct. 1997) and *U.S.* v. *Portland Cement Company of Utah*, 412 F.2d 894, in that a "profit" factor and an allocation of indirect costs have been improperly and erroneously considered so as to have the effect of eliminating more than the sole allowable direct costs of storage, bagging, shipping and related activities from the "proportionate profits" formula.

(b) In the treatment of the so-called "additivies" the Commissioner has disregarded prior Findings of Fact embodied in prior litigation involving this taxpayer and its income tax returns for prior years before the U.S. District Court for the Central District of Utah and the U.S. Court of Appeals for the Tenth Circuit, including the two cases referenced in the proceding sub-paragraph (a).

(c) The Commissioner has determined the deficiencies in each of the three years involved insofar as the same involve the so-called "additives" in a manner which violates well recognized accounting procedures, his own "proportionate profits" formula, and sound economic theory and practice; that the Commissioner's computations in arriving at the claimed deficiencies contain inconsistencies which destroy the formula which he uses, the formula magnifies the profit aspect and pre-kiln and post-kiln costs attributable to processing such so-called "additives" out of proportion to reality, and the Commissioner has failed to apply consistency throughout his "proportionate profits" formula in arriving at the percentage which mining costs bear to total costs of producing bulk cement (i.e. the first marketable product).

(d) There is no statutory or legal basis for applying the 50% limitation to taxable income in situations where the "proportionate profits" method of determining depletion is used.

(e) As to the fiscal year ending March 31, 1972, wherein there has been disallowed the sum of $2,734.00 as an expense for entertaining customers, petitioner affirmatively alleges that error has been committed for the reason that said amount, together with the balance of its entertainment expense deduction, was an ordinary, necessary and reasonable business expense expended in carrying on petitioner's business.

V. The facts upon which petitioner relies as the basis of this proceeding are as follows:

Pursuant to statutory law, prior and existing regulations of the Commissioner, decisions of the Tenth Circuit Court of Appeals (including those heretofore referred to), and accounting and economic theory, the "first marketable product" of this petitioner is bulk cement; that all subsequent costs in the distribution, storage and sales of such product, including bags and baggings, etc. are not "processes" to which said costs should be included in arriving at the percentage applicable under the "proportionate profits" formula.

In prior court cases involving the depletion matter respecting federal income taxes for prior years of this taxpayer it has been recognized that the purchased materials used by petitioner in making cements are simply "balancers" rather than additives, and that the bulk of these materials are simply basic cement—making ingredients which, when combined, produce cement by the application of the same processes applied to petitioner's own "cement rock." The processing costs of the "balancers" used are essentially the same—although slightly higher due to the differing physical characteristics of the purchased materials—as those applicable to processing petitioner's own "cement rock" into bulk cement.

Since petitioner is obligated to use the "proportionate profits" formula in arriving at gross income from mining and its ultimate depletion allowance, it is submitted that a percentage be arrived at showing the relationship between the volume of its own "cement rock" utilized and the volume of its purchased materials used as "balancers"; then, utilizing this percentage to all pre-kiln and post-kiln processing costs at and after the point where all materials merge together in the cement-making process, a correct result can be reached reflecting the profit attributable to petitioner's own "cement rock." By utilizing receipts from the sales of the "first marketable product" i.e. bulk cement, and excluding the costs of shipping, storage, bags and bagging and related items incurred after the first marketable product has been produced, it as then possible to arrive at the proper depletion allowance.

The method utilized by petitioner in preparing its corporate income tax return for the fiscal year ending March 31, 1972 reflects the proper procedure to be utilized.

With reference to the disallowed entertainment expenses petitioner will establish that the expenditures were directly related to the ordinary and necessary expenses normal to the conduct of its business in that the expenditures were made for the sole purpose of selling cement to customers in areas of Utah outside Salt Lake City; that none of the customers were in any sense social contacts of the company or of any of its officers or employees; that the affected customers were highly disposed to hunting, fishing and outdoor activities—and were not susceptible to being entertained or generally contacted for business purposes via other normal entertainment means; and that cement sales and related business matters constituted a very substantial portion of all conversations and discussions between the company president and the customers involved.

* * * * *

WHEREFORE, petitioner prays that this Court hear the proceeding and determine the actual amount of any tax

due from the petitioner for the three fiscal years here involved.

/s/ _____

GLEN E. FULLER
Counsel for Petitioner
15 East 4th South Street
Salt Lake City, Utah

* * * * *

[Verification omitted in reproduction]

Department of the Treasury

District Director
Internal Revenue Service

Date: MAY 23 1973 | In reply refer to: L-21, Code 411

Portland Cement Company of Utah
P. O. Box 1469
Salt Lake City, Utah 84110

CERTIFIED MAIL

Gentlemen:

Tax Year Ended:	Deficiency
3/31/1970	$44,200.00
3/31/1971	$41,509.00
3/31/1972	$ 7,175.00

This letter is to notify you—as required by law—that we have determined the income tax deficiencies shown above. I regret we have been unable to reach a satisfactory agreement in your case. The enclosed statement shows how the deficiencies were computed.

If you do not intend to contest this determination in the United States Tax Court, please sign and return the enclosed waiver form. This will permit an early assessment of the deficiencies and limit the accumulation of interest. The enclosed self-addressed envelope is for your convenience.

If you decide not to sign and return the waiver, the law requires that after 90 days from the date of mailing this letter (150 days if this letter is addressed to you outside the United States and the District of Columbia) we assess and bill you for the deficiencies. However, if within the time stated you contest this determination by filing a petition with the United States Tax Court, Box 70, Washington, D.C. 20044, we may not assess any deficiencies and bill you until after the Tax Court has decided your case. You may obtain a copy of the rules for filing a petition by writing to the Clerk of the Tax Court at the Court's Washington, D.C. address.

If you intend to file a petition with the United States Tax Court, you must do so within the time stated above (90 or 150 days, as the case may be); this period is fixed by law, and the Court cannot consider your case if your petition is filed late.

Sincerely yours,
Randolph W. Thrower Raymond F. Harless
Acting Commissioner
By

Roland V. Wise
Roland V. Wise
District Director

Enclosures:
Waiver
Statement
Envelope

Form L-21 (Rev. 5-70)

FORM 4607 (REV. MAY 1970)	DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE STATUTORY NOTICE STATEMENT	SYMBOLS L-21 A:NM:LOD:es

PORTLAND CEMENT COMPANY OF UTAH

P. O. BOX 1469

SALT LAKE CITY, UTAH
84110

KIND OF TAX

INCOME TAX

TAX YEAR ENDED	DEFICIENCY
3/31/1970	$44,200.00
3/31/1971	$41,509.00
3/31/1972	$ 7,175.00

☐ Copy to Authorized Representative

FORM 3613 (REV. JULY 1968) | DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE | STATEMENT SCHEDULE

CORPORATION INCOME TAX

1

NAME	TAXABLE YEARS ENDED		
Portland Cement Company of Utah	3/31/1970	3/31/1971	3/31/1972
TAXABLE INCOME AS SHOWN IN: [X] RETURN AS FILED [ ] PRELIMINARY LETTER DATED [ ] STATUTORY NOTICE DATED	865,870.00	774,115.00	1,498,711.00
INCREASES (DECREASES) IN INCOME *(See attached explanation of items)*			
(a) Depletion Expense	84,662.00	85,413.00	12,216.00
(b) Other Deductions - Customer Entertaining			2,734.00
TAXABLE INCOME AS REVISED	950,532.00	859,528.00	1,513,661.00
A. LESS: EXCESS OF NET LONG-TERM CAPITAL GAIN OVER NET SHORT-TERM CAPITAL LOSS *(Alternative tax computation)*			
B. INCOME SUBJECT TO TAX			
C. ~~ORIGINAL TAX~~	451,255.00	-0-	-0-
D. ~~TAX ON~~ AMOUNT SHOWN ON LINE A *(Alternative tax computation)* If Applicable See Schedule 2	-0-	406,122.00	720,488.00
E. TAX SURCHARGE	39,562.00	5,063.00	-0-
F. OTHER TAXES Investment Credit Recapture Per Return	308.00	-0-	-0-
G. SUBTOTAL *(Lines C, D, E and F)*	491,125.00	411,185.00	720,488.00
H. TAX CREDITS Investment Credit Per Return	4,547.00	531.00	5,044.00
I. INCOME TAX LIABILITY *(Line G less Line H)*	486,578.00	410,654.00	715,444.00
J. INCOME TAX LIABILITY SHOWN ON RETURN AND ADDITIONAL ASSESSMENT (OVERASSESSMENT) Document Locator No. 8731217100001	442,378.00		
Document Locator No. 8731211700015		369,145.00	
Document Locator No. 8731216900009			708,269.00
K. DEFICIENCY (OVERASSESSMENT)	44,200.00	41,509.00	7,175.00

TAX COMPUTATION

FORM 4549-D
(DECEMBER 1970)

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE

INCOME TAX AUDIT CHANGES

COMPUTATION OF ALTERNATIVE TAX - CORPORATIONS

TAXPAYER'S NAME: Portland Cement Company of Utah

EMPLOYER IDENTIFICATION NUMBER: 87-0165650

		Year:	Year: 3/30/71	Year: 3/30/72
PART I *Complete for all years*	1. CORRECTED TAXABLE INCOME (Schedule 1)		$ 859,528	$1,513,661
	2. NET LONG-TERM CAPITAL GAIN MINUS NET SHORT-TERM CAPITAL LOSS		7,438	5,938
	3. LINE 1 LESS LINE 2		852,090	1,507,723
	4. SURTAX EXEMPTION *(Line 3, $26,000, or amount apportioned under section 1561, whichever is lesser)*		25,000	25,000
	5. LINE 3 LESS LINE 4		827,090	1,482,723
	6. a. FOR YEARS ENDING BEFORE 1/1/70 - 25% OF LINE 2 b. FOR YEARS ENDING AFTER 12/31/69 - AMOUNTS FROM LINE 16		2,119	1,781
		Year: Year: 3/30/71 Year: 3/30/72		
	7. % 22 % 22 % OF LINE 3		187,460	331,699
	8. % 26 % 26 % OF LINE 5		215,043	385,508
	9. IF MULTIPLE SURTAX EXEMPTION ELECTED UNDER SECTION 1562, ENTER 6% OF LINE 4		1,500	1,500
	10. ALTERNATIVE TAX *(Add lines 6 through 9)*		406,122	720,488
PART II *Complete for all years ending after 12/31/69*	11. NET LONG-TERM CAPITAL GAIN REDUCED BY ANY NET SHORT TERM CAPITAL LOSS		7,438	5,938
	12. LONG-TERM CAPITAL GAIN *(section 1201 (d) IRC)**		-0-	-0-
	13. LINE 11 LESS LINE 12 *(if less than zero, enter zero)*		7,438	5,938
	14. 25% OF THE LESSER OF LINE 11 OR LINE 12		-0-	-0-
	15. a. FOR CALENDAR YEAR 1970 - 28% OF LINE 13 b. FOR CALENDAR YEARS 1971 THROUGH 1974 AND FISCAL YEARS ENDING IN 1972 THROUGH 1974 - 30% OF LINE 13 c. FOR FISCAL YEARS ENDING 1970 AND 1971 - AMOUNTS FROM LINES 19 & 22		2,119	1,781
	16. ADD LINES 14 AND 15 *(enter on line 6, above)*		2,119	1,781
PART III *Complete only for fiscal year ending in 1970*	17. AMOUNT ON LINE 13 x (NO. DAYS BEFORE 1/1/70 / 365) x 25%			
	18. AMOUNT ON LINE 13 x (NO. DAYS AFTER 12/31/69 / 365) x 28%			
	19. ADD LINES 17 AND 18 *(enter on line 15c, above)*			
PART IV *Complete only for a fiscal year ending in 1971*	20. AMOUNT ON LINE 13 x (NO. DAYS BEFORE 1/1/71 / 365) x 28%		1,569	
	21. AMOUNT ON LINE 13 x (NO. DAYS AFTER 12/31/70 / 365) x 30%		550	
	22. ADD LINES 20 AND 21 *(enter on line 15c, above)*		2,119	

*Long term capital gains from certain binding contracts, distributions, and installment sales

FORM 4549-D (12-70)

FORM 886-A (REV. APRIL 1968) | EXPLANATION OF ITEMS | SCHEDULE NO. 1-A

NAME OF TAXPAYER: Portland Cement Company of Utah | YEAR/PERIOD ENDED 3/31/1970 3/31/1971 & 3/31/1972

(a) It is held that since the taxable income from the property (computed without allowance for depletion deduction) derived from your limestone mine (quarry) was $271,739.00 for the taxable year ended March 31, 1970, and $220,957.00 for the taxable year ended March 31, 1971, as computed in Exhibit A attached hereto, your deduction for depletion under section 613 of the Internal Revenue Code of 1954 is $135,870.00 for the taxable year ended March 31, 1970, and $110,479.00 for the taxable year ended March 31, 1971.

It is held that since the gross income from mining derived from your limestone mine (quarry) was $1,251,312.00 for the taxable year ended March 31, 1972, as computed in Exhibit A attached hereto, your deduction for depletion under section 613 of the Internal Revenue Code of 1954 is $175,184.00.

Therefore, taxable income is increased as follows:

Taxable Year Ended	3/31/1970	3/31/1971	3/31/1972
Depletion on Cement Rock Claimed on your Return	$220,532.00	$195,892.00	$187,400.00
Depletion Allowable - As Computed in Exhibit A	135,870.00	110,479.00	175,184.00
Increase in Taxable Income	$ 84,662.00	$ 85,413.00	$ 12,216.00

(b) The deduction of $11,472.00 claimed for Other Deductions - Customer Entertaining is not allowed to the extent of $2,734.00 because it has not been established that any amount in excess of $8,738.00 represents an ordinary and necessary business expense or was expended for the purpose designated.

Therefore, taxable income is increased in the amount of $2,734.00.

Portland Cement Company of Utah [page 1]

EXHIBIT A

DEPLETION COMPUTATION

Computation to eliminate shipping, storing, bagging, and selling (distributive expenses) from actual sales receipts to arrive at constructive income from bulk cement produced from taxpayer's quarry rock at the silo.

Taxable Year Ended		3/31/1970
Gross Receipts from Sales as Adjusted (See Page 2, Note 1)		$3,817,390
Less: Receipts from Purchased Cement	$ 37,938	
Cash Discounts	164,623	202,561
Actual Receipts from Manufactured Cement		$3,614,829
Less: Receipts from Shipping, Bagging, Selling (Distributive Activities) (See Page 2, Note 2)		444,332
Receipts Attributable to Bulk Cement after Mfg.		$3,170,497
Less: Receipts from Purchased Additives (Page 2, Note 3)		328,174
Receipts (Sales) Allocable Between Mining, and Non-mining Processes after Elimination of Distribution Expenses and Purchased Additives - (Receipts Attributable to Bulk Cement)		$2,842,323

COMPUTATION OF GROSS INCOME FROM MINING

$$\text{Gross Income} = \frac{\text{Mining Cost (Page 2)}}{\text{Total Cost of Bulk Cement (Page 3)}} \times \text{Receipts Attributable to Bulk Cement (Page 1)}$$

$$\text{Gross Income} = \frac{707728}{2054730} \times 2842323$$

$$\text{Gross Income} = 34.45\% \times 2842323$$

$$\text{Gross Income} = \$979,180$$

Portland Cement Company of Utah [page 2]

EXHIBIT A

PERCENTAGE DEPLETION - PROPORTIONATE PROFITS COMPUTATION

Taxable Year Ended		3/31/1970
1. Gross Income from Mining (Page 1)		$ 979,180
2. Less: Mining Costs (Page 3)	***	707,441
3. Taxable Income from Property		271,739
4. 50% of Line 3		135,870
5. 15% of Gross Income from Mining		146,877
6. Allowable Depletion		135,870

*** Mining Costs (Page 3)	$ 707,728	
Less: Contributions Included in Indirect Costs (27.08% of 1058)	(287)	
Total Mining Costs	$ 707,441	

(Note 1) Gross Receipts Net of Empty Bags		$3,799,356
Add: Bag Costs (Credit to Bag Inv. Account)		18,034
Gross Receipts from Sales as Adjusted		$3,817,390
Note 2) Computation of Receipts Attributable to Shipping, Bagging, Selling (Distributive) Activities		
Direct Storage and Shipping Expenses		$ 182,108
Selling Expense		82,447
Bag Costs (Credits to Bag Inventory Account)		18,034
		$ 282,589
Allocated Indirect Costs (Page 3)		38,622
Total Direct and Indirect Costs (Page 3)		321,211
Profit Allocated to Shipping, Selling, etc., on Cost -(Page 4)		123,121
Receipts Attributable to Shipping, Selling, etc.		$ 444,332
Note 3) Computation of Receipts Attributable to Purchased Additives		
Direct Cost of Purchased Additives		$ 129,359
Direct Cost of Processing Additives		79,347
Allocated Indirect Costs - (Page 3)		28,534
Total Direct and Indirect Cost of Additives (Page 3)		$ 237,240
Profit Allocated to Purchased Additives (Page 4)		90,934
Receipts Attributable to Purchased Additives		$ 328,174

Portland Cement Company of Utah [page 3]

EXHIBIT A

ALLOCATION OF INDIRECT COSTS IN PROPORTION TO DIRECT COSTS

Fiscal Year 3/31/1970

		Direct Costs	%	Indirect Costs	Total Cost
(1)	Mining	$ 622,627	27.08	$ 85,100	$ 707,728
(2)	Non Mining	$1,185,004	51.55	$161,999	$1,347,002
(3)	Shipping, Storing, Etc.	$ 282,589	12.29	$ 38,622	$ 321,210
(4)	Additives	$ 208,705	9.08	$ 28,534	$ 237,240
	Totals	$2,298,925	100.00	$314,255	$2,613,180

(1) Mining Costs:

Quarry	$ 221,605
Hauling Quarry Rock	96,496
Raw Grinding and Blending ($513,231 - $129,359 x 79.33%) (a) (b)	304,526

(b) Raw Materials Purchased / Total Raw Materials Used

Total Direct	$ 622,627

(2) Non-Mining Costs:

Burning and Cooling	$ 917,352
Finish Grinding	267,652
Total	$1,185,004

(3) Shipping, Storing, Bagging & Selling Costs:

Storing and Shipping	$ 182,108
Selling	82,447
Bag Costs (Credits to Bag Inventory Acct.)	18,034
Total	$ 282,589

(4) Additives:

Cost of Purchased Lime, Silica & Slag	$ 129,359	(a)
Cost of Processing Additives $513,231 - $129,359 x 20.67% (2)	79,346	
Direct Costs Attributable to Additives	$ 208,705	

Portland Cement Company of Utah [page 4]

EXHIBIT A

COMPUTATION OF PROFIT ON COST

Fiscal Year 3/31/1970

Actual Receipts from Manufactured Cement (Page 1)	$3,614,829
Total Cost of Manufactured Cement (Page 3)	2,613,181
Total Profit on Manufactured Cement Sales	$1,001,648

$$\frac{\text{Profit}}{\text{Cost}} \quad \frac{1,001,648}{2,613,181} = 38.33\%$$

Profit Attributable to Storing & Shipping, Bagging & Selling Expenses

321,211 x 38.33% = $123,121

Profit Attributable to Purchased Additives

237,240 x 38.33% = $90,934

Portland Cement Company of Utah [page 5]

EXHIBIT A

SCHEDULE OF INDIRECT COSTS

Fiscal Year 3/31/1970

General and Administrative Expenses Per CPA Report		$160,984
Interest Expense	$95,356	
Less: Interest not Attributable to Cement Operations	22,508	72,848
Inventory Adjustment		12,814
Utah Franchise Tax		17,299
Loss on Scrapped Fixed Assets		46,079
Loss - Sale of Scrap		(863)
Amortization of Loan Costs		3,094
Total		$314,255

Portland Cement Company of Utah [page 6]

EXHIBIT A

DEPLETION COMPUTATION

Computation to eliminate shipping, storing, bagging and selling (distributive expenses) from actual sales receipts to arrive at constructive income from bulk cement produced from taxpayer's quarry rock at the silo.

Taxable Year Ended		3/31/1971
Gross Receipts from Sales as Adjusted (See Page 7, Note 1)		$3,610,112
Less: Receipts from Purchased Cement	$ 46,114	
Cash Discounts	150,987	197,101
Actual Receipts from Manufactured Cement		$3,413,011
Less: Receipts from Shipping, Bagging, Selling (Distributive Activities) (See Page 8, Note 2)		447,626
Receipts Attributable to Bulk Cement After Mfg.		$2,965,385
Less: Receipts from Purchased Additives (See Page 8, Note 3)		357,721
Receipts (Sales) Allocable Between Mining and Non-mining Processes after Elimination of Distribution Expenses (Receipts Attributable to Bulk Cement)		$2,607,664

COMPUTATION OF GROSS INCOME FROM MINING

Gross Income = $\frac{\text{Mining Cost}}{\text{Total Cost of Bulk Cement}}$ X Receipts Attributable to Bulk Cement (Page 6)

Gross Income = $\frac{\$\ 656,683}{1,951,459}$ X $2,607,664

Gross Income = 33.65% X $2,607,664

Gross Income = $ 877,479

Portland Cement Company of Utah [Page 7]

EXHIBIT A

PERCENTAGE DEPLETION - PROPORTIONATE PROFITS COMPUTATION

Fiscal Year 3/31/1971

1.	Gross Income from Mining (Page 6)			$ 877,479
2.	Less: Mining Costs		***	656,522
3.	Taxable Income from Property			220,957
4.	50% of line 3			110,479
5.	14% of Gross Income from Mining			122,847
6.	Allowable Depletion			110,479

***	Mining Costs (Page 8)	$656,683	
	Less: Contributions Included in Indirect Costs (25.71% of 625)	(161)	
	Total Mining Costs	$656,522	

(Note 1)	Gross Receipts Net of Empty Bags		$3,591,699
	Add: Bag Costs (Credit to Bag Inv. Acct.)		18,413
	Gross Receipts as Adjusted		$3,610,112
(Note 2)	Computation of Receipts Attributable to Shipping, Bagging, Selling (Distributive) Activities		
	Direct Storing & Shipping Expense		$ 217,970
	Direct Selling Expense		67,379
	Bag Costs (Credits to Bag Inventory Account)		18,412
			$ 303,761
	Allocated Indirect Costs (Page 8)		31,237
	Total Direct & Indirect Costs (Page 8)		$ 334,998
	Profit Allocated to Shipping, Selling, Etc., on Cost (Page 9)		112,628
	Receipts Attributable to Shipping, Selling, Etc.		$ 447,626
(Note 3)	Computation of Receipts Attributable to Purchased Additives		
	Direct Cost of Purchased Additives		$ 134,905
	Direct Cost of Processing Additives		107,858
	Allocated Indirect Costs (Page 8)		24,952
	Total Direct & Indirect Costs (Page 8)		$ 267,715
	Profit Allocated to Purchased Additives (Page 9)		90,006
	Receipts Attributable to Purchased Additives		$ 357,721

Portland Cement Company of Utah [page 8]

EXHIBIT A

ALLOCATION OF INDIRECT COSTS IN PROPORTION TO DIRECT COSTS

Fiscal Year 3/31/1971

		Direct Costs	%	Indirect Costs	Total Cost
(1)	Mining	$ 595,470	25.71	$ 61,213	$ 656,683
(2)	Non-mining	1,174,089	50.69	120,687	1,294,776
(3)	Shipping, Storing, etc.	303,761	13.12	31,237	334,998
(4)	Additives	242,763	10.48	24,952	267,715
		$2,316,083	100.00	$238,089	$2,554,172

(1)	Mining Costs			
	Quarry		$ 225,753	
	Hauling Quarry Rock		88,758	
	Raw Grinding and Blending			
	($523,722 - $134,905 x 72.26%)		280,959	
	(a) (b)			
	(b) Raw Materials Purchased			
	Total Raw Materials Used			
	Total Direct		$ 595,470	
(2)	Non-mining Costs			
	Burning and Cooling		$ 852,550	
	Finish Grinding		321,539	
	Total		$1,174,089	
(3)	Storing, Shipping, Bagging & Selling Costs			
	Storing and Shipping		$ 217,971	
	Selling		67,378	
	Bag Costs		18,412	
	Total		$ 303,761	
(4)	Additives			
	Cost of Purchased Lime, Silica & Slag		$ 134,905	(a)
	Cost of Processing Additives			
	($523,722 - $134,905 x 27.74%)		107,858	
	Direct Costs Attributable to Additives		$ 242,763	

Portland Cement Company of Utah [page 9]

EXHIBIT A

COMPUTATION OF PROFIT ON COST

Fiscal Year 3/31/1971

Actual Receipts from Manufactured Cement (Page 6)	$3,413,010
Total Cost of Manufactured Cement (Page 8)	2,554,172
Total Profit on Manufactured Cement Sales	$ 858,838

$$\frac{\text{Profit}}{\text{Cost}} \quad \frac{858,838}{2,554,172} = 33.62\%$$

Profit Attributable to Storing, Shipping, Bagging & Selling Expenses

334,999 x 33.62% = $112,628

Profit on Purchased Additives

267,715 x 33.62% = $ 90,006

Portland Cement Company of Utah [page 10]

EXHIBIT A

SCHEDULE OF INDIRECT COSTS

Fiscal Year 3/31/1971

General and Administrative Expenses Per CPA Report		$115,056
Interest Expense	$87,106	
Less: Interest not Attributable to Cement Operations	22,508	64,598
Inventory Adjustment		5,794
Total		$185,447
Utah Franchise Tax		33,419
Loss on Fixed Assets Scrapped		18,520
Amortization of Loan Costs		3,094
Less: Sale of Scrap		(2,392)
Total		$238,089

Portland Cement Company of Utah [page 11]

EXHIBIT A

DEPLETION COMPUTATION

Computation to eliminate shipping, storing, bagging and selling (distributive expenses) from actual sales receipts to arrive at constructive income from bulk cement produced from taxpayer's quarry rock at the silo.

Taxable Year Ended		3/31/1972
Gross Receipts from Sales as Adjusted (See Page 12, Note 1)		$4,911,925
Less: Receipts from Purchased Cement	$ 44,687	
Cash Discounts	191,779	236,466
Actual Receipts from Manufactured Cement		$4,675,459
Less: Receipts from Shipping, Bagging, Selling (Distributive Activities) (See Page 12, Note 2)		561,298
Receipts Attributable to Bulk Cement after Mfg.		$4,114,161
Less: Receipts from Purchased Additives (See Page 12, Note 3)		325,750
Receipts Allocable Between Mining and Non-mining Processes after Elimination of Distributions Expenses & Purchased Additives (Receipts Attributable to Bulk Cement)		$3,788,411

COMPUTATION OF GROSS INCOME FROM MINING

$$\text{Gross Income} = \frac{\text{Mining Cost}}{\text{Total Cost of Bulk Cement}} \times \text{Receipts Attributable to Bulk Cement}$$

$$\frac{828,214}{2,567,152} = 33.03\% \times \$3,788,411 = \$1,251,312$$

Portland Cement Company of Utah [page 12]

EXHIBIT A

PERCENTAGE DEPLETION - PROPORTIONATE PROFITS COMPUTATION

Taxable Year Ended			3/31/1972
1. Gross Income from Mining (Page 11)			$1,251,312
2. Less: Mining Costs (Page 13)		***	827,764
3. Taxable Income from Property			423,548
4. 50% of Line 3			211,774
5. 14% of Gross Income from Mining			175,184
6. Allowable Depletion			175,184

*** Mining Costs	$828,214	
Less: Contributions Included in Direct Costs (26.77% of 1,680)	450	
Total Mining Costs	$827,764	

(1) Gross Receipts Net of Empty Bags		$4,891,898
Add: Bag Costs (Credits to Bag Inventory)		20,027
Gross Receipts from Sales as Adjusted		$4,911,925
(2) Computation of Receipts Attributable to Shipping, Bagging & Selling		
Direct Storage and Shipping Expense		$ 228,748
Direct Selling Expenses		72,190
Bag Costs (Credits to Bag Inventory)		20,027
		$ 320,961
Allocated Indirect Costs (Page 13)		50,488
Total Direct and Indirect Costs (Page 13)		$ 371,449
Profit Allocated to Shipping, Selling, etc. (Page 14)		189,849
Receipts Attributable to Shipping, Selling, etc.		$ 561,298
(3) Computation of Receipts Attributable to Purchased Additives		
Direct Cost of Purchased Additives		$ 112,010
Direct Cost of Processing Additives		74,236
Allocated Indirect Costs (Page 13)		29,325
Total Direct & Indirect Cost of Additives (Page 13)		215,571
Profit Allocated to Purchased Additives (Page 14)		110,179
Receipts Attributable to Purchased Additives		$ 325,750

Portland Cement Company of Utah [Page 13]

EXHIBIT A

ALLOCATION OF INDIRECT COSTS IN PROPORTION TO DIRECT COSTS

Fiscal Year 3/31/1972

		Direct Costs	%	Indirect Costs	Total Cost
(1)	Mining	$ 715,583	26.77	$112,631	$ 828,214
(2)	Non-mining	1,450,648	54.26	228,291	1,678,939
(3)	Shipping, Storing, etc.	320,961	12.00	50,488	371,449
(4)	Additives	186,246	6.97	29,325	215,571
	Totals	$2,673,438	100.00	$420,735	$3,094,173

(1) Mining Costs

Quarry	$ 267,041	
Hauling Quarry Rock	120,196	
Raw Grinding and Blending		
(514,593 - 112,010 x 81.56%)	328,346	
1 2		
2. Raw Material Purchased		
Total Raw Material Used		
Total Direct	$ 715,583	

(2) Non-mining Costs

Burning and Cooling	$1,125,824	
Finish Grinding	324,824	
Total	$1,450,648	

(3) Storing and Shipping, Bagging & Selling Costs

Storing and Shipping	$ 228,744	
Selling	72,190	
Bag Costs (Credits to Bag Inventory)	20,027	
Total	$ 320,961	

(4) Additives

Cost of Purchased Lime, Silica & Slag	$ 112,010	1
Cost of Processing Additives		
(514,592 - 112,010 x 18.44%)	74,236	
Direct Cost Attributable to Additives	$ 186,246	

Portland Cement Company of Utah [Page 14]

EXHIBIT A

COMPUTATION OF PROFIT ON COST

Fiscal Year 3/31/1972

Actual Receipts from Manufactured Cement (Page 11)	$4,675,459
Total Cost of Manufactured Cement (Page 13)	3,094,173
Total Profit on Manufactured Cement Sales	$1,581,286

$$\frac{\text{Profit}}{\text{Cost}} \quad \frac{1,581,286}{3,094,174} = 51.11\%$$

Profit Attributable to Storing, Shipping, Bagging & Selling Expenses

371,449 x 51.11% = $189,849

Profit Attributable to Purchased Additives

215,571 x 51.11% = $110,179

Portland Cement Company of Utah

[page 15]

EXHIBIT A

SCHEDULE OF INDIRECT COSTS

Fiscal Year 3/31/1972

General and Administrative Expenses		$135,031
Interest Expense	$ 78,856	
Less: Interest not Attributable to Cement Operations	22,508	56,348
Amortization of Loan Costs		3,094
Loss on Fixed Assets Scrapped		26,378
Less: Sale of Scrap		(2,063)
Inventory Adjustment		35,142
Utah Franchise Tax		33,433
Interest Paid on Federal Income Tax Deficiencies	$144,427	
Less: Interest Received on Federal Tax Refund	2,995	141,432
		$428,795
Less: Non-deductible Expenses Included in General & Administrative Expenses (Life Insurance Premiums)		(8,060)
		$420,735

UNITED STATES TAX COURT

Docket No. 6306–73

[Filed September 13, 1973]

PORTLAND CEMENT COMPANY OF UTAH, a corporation, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits and denies as follows:

I, II and III. Admits the allegations of paragraphs I, II and III of the petition.

IV (a) to (e), inclusive. Denies the allegations of subparagraphs (a) to (e), inclusive, of paragraph IV of the petition.

V. Denies the allegations of each subparagraph of paragraph V of the petition.

VI. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiencies determined by the respondent be in all respects approved.

/s/ _____

LAWRENCE B. GIBBS/DRB
Acting Chief Counsel
Internal Revenue Service

OF COUNSEL:

EMORY L. LANGDON,
Regional Counsel

S. CLAY FREED,
Attorney

Internal Revenue Service
125 South State Street, Room 3438
Salt Lake City, Utah 84111

UNITED STATES TAX COURT

Docket No. 6306-73

[Filed January 20, 1975]

PORTLAND CEMENT COMPANY OF UTAH, A Corporattion,)
Petitioner,)
)
v.)
)
COMMISSIONER OF INTERNAL REVENUE, Respondent.)

STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part thereof; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. During each of the years at issue, Portland Cement Company of Utah had its principal place of business at Salt Lake City, Utah.

2. Attached are copies of U.S. Corporation Income Tax Returns (Forms 1120) filed by the petitioner with the Western Service Center at Ogden, Utah:

Fiscal Year Ending	*Joint Exhibit No.*
March 31, 1970	A-1
March 31, 1971	B-2
March 31, 1972	C-3

3. Portland Cement Company of Utah (hereinafter referred to as "taxpayer") has been for many years and was, during the years in question, engaged in the quarrying of an argillaceous limestone rock and the processing of that rock into finished portland cement. This argillaceous limestone is known in the trade as "cement rock." Taxpayer's "cement rock" is referred to in *Internal Revenue*

Code of 1954, § 613(b)(7) as "calcium carbonates" or "limestone." Taxpayer's rock is not used for any purpose other than processing into cement.

4. Taxpayer's cement rock is mined from its own quarry located in Parley's Canyon, 12 miles east of its cement plant. Taxpayer's cement plant is located at Eighth South Street and Sixth West Street in Salt Lake City, Utah.

5. Taxpayer's operations conducted at its quarry in Parley's Canyon may be described briefly as follows: the cement rock is first blasted loose from the mountainous quarry. The blasted rock is ripped by a bulldozer and pushed over the edge of the working bench down to the quarry floor. If necessary, secondary blasting or a drop ball is used to reduce the size of large boulders. The loose rock is loaded into trucks and transported to a jaw crusher where it is further reduced in size. It is then conveyed to impactors that reduce the material to a final size less than 1 inch. The crushed material is stored temporarily at the quarry in bins prior to loading into trucks for transportation to the taxpayer's cement plant.

6. Taxpayer's operations conducted at its cement plant in Salt Lake City may be described briefly as follows: the material is unloaded from the trucks transporting it from the quarry site and is placed in open stockpiles. Crushed purchased iron slag, silica and high lime rock are also placed in open stockpiles. When necessary, certain amounts of crushed purchased iron slag, silica, and/or high lime rock are fed into rod-ball mills along with the crushed rock mined by the taxpayer; and all of the material is ground to a fineness so that 75% volume passes through a 200 mesh sieve. Water is added in the rod-ball mills for the purpose of grinding and blending and to form a slurry similar to fine mud. The slurry is placed in tanks where it is continually agitated to keep the solids from settling, in order to maintain the proper blend of materials to produce a finished product which meets the specification for portland cement. The slurry is then fed into rotary kilns where it is burned. While in the kiln moisture is expelled and carbonates are converted to oxides while the material is

heated to a point of incipient fusion. Complex silicates and aluminates are formed by chemical reactions occurring in the kiln. A "clinker" results from the burning process. The clinker is cooled and later ground with purchased gypsum to produce finished cement.

7. The rock in taxpayer's quarry varies in chemical composition from one area to another. Any given area within the quarry does not always contain all the ingredients necessary to produce finished portland cement. When rock is quarried from such an area, it is necessary to add to taxpayer's cement rock other materials such as high lime rock, iron slag and/or silica. High lime rock is added to correct any calcium carbonate deficiency in taxpayer's quarry rock; iron slag is added to correct any iron deficiency in the quarry rock; and silica is added to compensate for any lack of silica oxides in the rock. If the required amounts of calcium carbonate, iron and silica oxides are not present in the slurry as it is introduced into the kiln, chemical actions required to produce a clinker from which portland cement can be made will not occur. It is only when the proper proportions of materials are introduced into the rod-ball mill that the necessary chemical reactions will take place during the burning in the kiln. In fact, chemical analyses are made by taxpayer's chemists to ensure that the slurry is of a proper composition for making portland cement.

8. The following shows facts concerning high lime rock purchased from others and used by taxpayer during the fiscal year in the making of cement:

Year	*Dollar Amount Purchased*	*Tons Purchased*
FY ending 3/31/70	$ 95,918.12	34,997
FY ending 3/31/71	$105,085.53	45,391
FY ending 3/31/72	$ 84,085.55	35,789
Totals	$285,089.20	116,177

9. The following shows facts concerning iron slag purchased from others and used by taxpayer during the fiscal year in the making of cement:

Year	*Dollar Amount Purchased*	*Tons Purchased*
FY ending 3/31/70	$ 4,397.45	2,728
FY ending 3/31/71	$ 3,038.76	1,820
FY ending 3/31/72	$ 4,171.26	2,498
Totals	$11,607.47	7,046

10. The following shows facts concerning silica purchased from others and used by taxpayer during the fiscal year in the making of cement:

Year	*Dollar Amount Purchased*	*Tons Purchased*
FY ending 3/31/70	$29,043.15	13,567
FY ending 3/31/71	$26,780.62	14,740
FY ending 3/31/72	$23,752.99	15,347
Totals	$79,576.76	43,654

11. During each of the years shown below, taxpayer quarried and used the following tonnages of cement rock in the making of portland cement:

Fiscal Year Ending	*Tons of Cement Rock*
March 31, 1970	196,903
March 31, 1971	161,379
March 31, 1972	237,211

12. During each of the years shown, taxpayer incurred the following quarry costs, which are considered mining costs in the application of the proportionate profits formula:

Fiscal Year Ending	*Amount*
March 31, 1970	$221,604.56
March 31, 1971	$225,752.56
March 31, 1972	$267,040.52

13. During each of the years shown, taxpayer incurred the following costs for hauling quarry rock, which are considered mining costs in the application of the proportionate profits formula:

Fiscal Year Ending	*Amount*
March 31, 1970	$ 96,496.40
March 31, 1971	$ 88,758.45
March 31, 1972	$120,195.90

14. During each of the years shown, taxpayer incurred the following costs for raw grinding and blending of materials used by it in the production of finished cement. The costs shown were incurred to grind and blend simultaneously both materials mined by the taxpayer and, when used, high lime rock, slag and silica purchased by the taxpayer from others. Raw grinding and blending is a process applied prior to the introduction of the kiln feed into the kiln:

Fiscal Year Ending	*Amount*
March 31, 1970	$383,872.61
March 31, 1971	$388,817.42
March 31, 1972	$402,582.94

15. During each of the years shown, taxpayer incurred the following costs for burning and cooling of materials used by it in the production of finished cement. The costs shown were incurred to burn the ground and blended materials referred to in paragraph 14 and cool the clinker resulting from such burning. Burning and cooling are processes applied subsequent to the introduction of the kiln feed into the kiln.

Fiscal Year Ending	*Amount*
March 31, 1970	$ 917,352.00
March 31, 1971	$ 852,549.97
March 31, 1972	$1,125,823.86

16. During each of the years shown, taxpayer incurred the following costs to finish grind the clinker. Finish grinding is a process applied subsequent to the introduction of the kiln feed into the kiln:

Fiscal Year Ending	*Amount*
March 31, 1970	$267,651.96
March 31, 1971	$321,539.18
March 31, 1972	$324,823.65

17. During each of the years shown, taxpayer paid the following amounts as dues to the Portland Cement Association:

Fiscal Year Ending	*Amount*
March 31, 1970	$35,268.85
March 31, 1971	$20,032.84
March 31, 1972	$18,186.85

The parties agree as to these years such costs are to be apportioned to mining and nonmining based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other.

18. During each of the years shown, taxpayer's gross sales of bulk and bagged cement were reported on its tax returns as follows:

Fiscal Year Ending	*Amount*
March 31, 1970	$3,799,355.81
March 31, 1971	$3,591,698.61
March 31, 1972	$4,891,897.56

Under taxpayer's accounting procedure, these figures did not include the cost of bags used in selling bagged cement.

19. During each of the years shown, taxpayer incurred the following costs for bags used in selling bagged cement:

Fiscal Year Ending	*Amount*
March 31, 1970	$18,034.00
March 31, 1971	$18,413.00
March 31, 1972	$20,027.00

20. During each of the years shown, taxpayer allowed the following cash discounts on all sales of cement. The parties agree that the amounts shown are proper subtractions from gross sales in applying the proportionate profits formula:

Fiscal Year Ending	*Amount*
March 31, 1970	$164,622.74
March 31, 1971	$150,987.27
March 31, 1972	$191,778.89

21. During each of the years shown, taxpayer purchased cement from others and resold the purchased cement to its own customers at the following amounts after cash discounts. The parties agree that the amounts shown are proper subtractions from gross sales in applying the proportionate profits formula:

Fiscal Year Ending	*Amount*
March 31, 1970	$37,937.97
March 31, 1971	$46,113.57
March 31, 1972	$44,687.34

22. During each of the years shown, taxpayer incurred the following expenses attributable to storing, shipping and bagging finished cement:

Fiscal Year Ending	*Amount*
March 31, 1970	$182,108.16
March 31, 1971	$217,970.58
March 31, 1972	$228,744.12

23. During each of the years shown, taxpayer incurred the following indirect expenses:

Fiscal Year Ending	*Amount*
March 31, 1970	$314,255.59
March 31, 1971	$238,088.71
March 31, 1972	$420,735.30

Such expenses are not identifiable with a particular mining or nonmining activity or process. However, the expenses apply to the entire cement producing operation. The parties agree that such costs are to be apportioned to mining and to nonmining based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other.

24. During each of the years shown, taxpayer deducted the following amounts on its tax returns for charitable contributions:

Fiscal Year Ending	*Amount*
March 31, 1970	$1,058.00
March 31, 1971	$ 625.00
March 31, 1972	$1,680.00

The parties agree that these deductions are not treated as costs in application of the proportionate profits formula.

25. Attached are copies of Report on Examination of Financial Statements and Supplemental Data prepared for taxpayer, as follows:

Fiscal Year Ending	*Joint Exhibit No.*
March 31, 1971 and 1970	D-4
March 31, 1972 and 1971	E-5

26. During each of the years shown, taxpayer incurred the following selling expenses:

Type of Expense	*March 31 1970*	*March 31 1971*	*March 31 1972*
Salaries	$23,000.00	$24,700.00	$26,140.00
Advertising & Public Relations	$ 5,618.86	$ 6,408.85	$ 6,108.64
Travel & Entertainment	$ 8,826.07	$ 8,651.95	$11,471.58
Automobile Expense	$ 6,893.04	$ 5,024.49	$ 6,368.31
Profit-sharing Plan Contribution	$ 2,840.50	$ 2,559.90	$ 3,915.10
Totals	$47,178.47	$47,345.19	$54,003.63

27. That portion of its cement sold by the taxpayer in bags is the same material as the cement sold in bulk.

28. Respondent concedes that for the fiscal year ending March 31, 1972, taxpayer's correct deduction for travel and entertainment is $11,471.58.

MEADE WHITAKER
Chief Counsel
Internal Revenue Service

By: /s/ _____
T. W. SOMMER
Assistant Regional Counsel
Room 3438, 125 South State
P.O. Box 11189
Salt Lake City, Utah 84111
(801) 524-5815

/s/ _____
GLEN E. FULLER
Counsel for Petitioner
15 East Fourth South
Salt Lake City, Utah 84111

JAN. 15, 1975

8731217100301

Form **1120** — Department of the Treasury, Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1969 or other taxable year beginning 12 1 70 April 1, 1969, ending March 31, 1970 (PLEASE TYPE OR PRINT)

1969

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (see page 7 of instructions) 3240

Name: SC 87-0165650 FCR MAR 31 1970 DC87
Num: PORTLAND CEMENT COMPANY OF UTAH
FCX 1469
City: SALT LAKE CITY UT 84110

D Employer Identification No. 87-0165650
E County in which located: Salt Lake
F Enter total assets from line 14, column (D), Schedule L (See instruction R): $5,664,974.66

IMPORTANT—Fill in all applicable lines and schedules. If the lines on the schedules are not sufficient, see instruction N.

GROSS INCOME	1 Gross receipts or gross sales 3,799,355.81 Less: Returns and allowances 164,622.74		3,634,733.07
	2 Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)		2,065,642.74
	3 Gross profit		1,569,090.33
	4 Dividends (Schedule C)		9,190.40
	5 Interest on obligations of the United States and U.S. instrumentalities		22,411.95
	6 Other interest		76,622.34
	7 Gross rents		
	8 Gross royalties		
	9 Net gains (losses)—(separate Schedule D)		875.79
	10 Other income (attach schedule) Schedule 2		5,566.06
	11 TOTAL income—Add lines 3 through 10		1,683,756.87
DEDUCTIONS	12 Compensation of officers (Schedule E)		32,536.00
	13 Salaries and wages (not deducted elsewhere)		98,837.79
	14 Repairs (do not include capital expenditures)		
	15 Bad debts (Schedule F if reserve method is used)		41,778.85
	16 Rents		30,000.00
	17 Taxes (attach schedule) Schedule 3		21,681.60
	18 Interest		95,356.25
	19 Contributions (not over 5% of line 28 adjusted per instructions—attach schedule) Schedule 4		1,058.00
	20 Casualty or theft losses (attach schedule)		
	21 Amortization (attach schedule) Schedule 5		3,094.20
	22 Depreciation (Schedule G)		11,845.67
	23 Depletion Schedules 7 and 8		220,631.19
	24 Advertising		5,618.86
	25 (a) Pension, profit-sharing, stock bonus, annuity plans (attach Form 2950) Excluding amounts included in schedule 1		9,600.20
	(b) Other employee benefit plans (see instructions) Schedule 13		1,924.53
	26 Other deductions (attach schedule) Schedule 9		236,112.01
	27 TOTAL deductions on lines 12 through 26		810,075.15
	28 Taxable income before net operating loss deduction and special deductions (line 11 less line 27)		873,681.72
	29 Less: (a) Net operating loss deduction (see instructions—attach schedule)		
	(b) Special deductions (Schedule I) 7,811.84		7,811.84
	30 Taxable income (line 28 less line 29)		865,869.88
TAX	31 TOTAL TAX (Schedule J)		442,377.64
	32 Credits: (a) Tax deposited—Form 7004 application for extension (attach copy)		
	(b) 1969 estimated tax payments (include 1968 overpayment allowed as a credit—do not include any "quick refund" of overpayment of 1969 estimated tax applied for on Form 4466) 497,646.93		
	(c) Credit from regulated investment companies (attach Form 2439)		
	(d) Credit for U.S. tax on nonhighway gas and lube oil (attach Form 4136)		497,646.93
	33 TAX DUE (line 31 less line 32). See instruction G for tax deposit system	→	(55,269.29)
	34 OVERPAYMENT (line 32 less line 31)	→	
	35 Enter amount of line 34 you want: Credited to 1970 estimated tax ▶ 55,269.29 Refunded ▶		

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than the taxpayer, my declaration is based on all information of which he has any knowledge.

CORPORATE SEAL

Date: [illegible] Signature of officer: [illegible] Title: A-1

[illegible], Walker Bank Bldg., Salt Lake City, Utah
Address

[Exhibit A-1]

Received — Internal Revenue Service Center — Ogden, Utah — MAR 1970 — NC. 57

Schedule J—TAX COMPUTATION (Fiscal year corporations, see page 6 of instructions)

1 Taxable income (line 30, page 1)		865,869.88
2 Surtax exemption (line 1, $25,000, or amount apportioned under section 1561, whichever is lesser)		25,000.00
3 Line 1 less line 2		840,869.88
4 (a) 22% of line 1	190,491.37	
(b) 76% of line 3	218,626.17	
(c) If multiple surtax exemption is elected under section 1562, enter 6% of line 2	1,500.00	410,617.54
5 (a) Income tax (line 4, or line 24 of separate Schedule D, whichever is lesser)	410,617.54	
(b) Tax Surcharge—10% of line 5(a) Fiscal year - 08767123	35,999.34	446,616.88
6 Foreign tax credit (attach Form 1118)		
7 Line 5 less line 6		446,616.88
8 Investment credit (attach Form 3468)		4,547.03
9 Line 7 less line 8		442,069.85
10 (a) Personal holding company tax (attach Schedule 1120 PH)		
(b) Tax Surcharge—10% of line 10(a)		
11 Tax from recomputing a prior year investment credit (attach Form 4255)		307.79
12 Total tax—Add lines 9, 10, and 11. Enter here and on line 31, page 1		442,377.64

Form 1120 (1969) **Schedule L—BALANCE SHEETS** Page 4

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash		1,232,895.51		633,366.42
2 Trade notes and accounts receivable	154,152.76		165,413.21	
(a) Less allowance for bad debts	4,160.81	149,991.95	3,989.74	161,423.47
3 Inventories		253,179.73		250,552.88
4 Gov't obligations: (a) U.S. and instrumentalities				1,153,261.26
(b) State, subdivisions thereof, etc Schedule 11		26,280.03		91,735.60
5 Other current assets (attach schedule)				
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule) Quarry claims		41,728.56		41,728.56
9 Buildings and other fixed depreciable assets	6,334,907.60		6,345,126.14	
(a) Less accumulated depreciation	3,053,715.68	3,281,191.92	3,275,371.58	3,069,754.56
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)		1,661.00		10,286.00
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule) Schedule 11		254,300.51		252,865.91
14 Total assets		5,241,229.21		5,664,974.66
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable		83,977.91		134,994.05
16 Mtges., notes, bonds payable in less than 1 yr.		150,000.00		150,000.00
17 Other current liabilities (attach schedule) Schedule 11		58,938.39		95,189.28
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more		1,650,000.00		1,500,000.00
20 Other liabilities (attach schedule) Provision for additional income taxes		331,580.54		445,734.20
21 Capital stock: (a) Preferred stock				
(b) Common stock	379,900.00	379,900.00	379,900.00	379,900.00
22 Paid-in or capital surplus (attach reconciliation)		7,000.00		7,000.00
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated		2,613,832.37		2,974,257.13
25 Less cost of treasury stock		(34,000.00)		(22,100.00)
26 Total liabilities and stockholders' equity		5,241,229.21		5,664,974.66

Schedule M-1—RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

1 Net income per books	540,940.76	7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax	442,377.64	(a) Tax-exempt interest $	
3 Excess of capital losses over capital gains		Equity in net income of subsidiary	12,171.54
4 Taxable income not recorded on books this year (itemize)		8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (itemize)		(a) Depreciation $	
(a) Depreciation $		(b) Depletion $ 220,631.19	
(b) Depletion $		Deferred fed. income tax 7,107.90	
Utah franchise tax	33,419.24	Utah franch. tax 17,298.95	245,038.04
Provision for prior years' add. tax	114,153.66	9 Total of lines 7 and 8	257,209.58
6 Total of lines 1 through 5	1,130,891.30	10 Income (line 28, page 1)—line 6 less 9	873,681.72

Schedule M-2—ANALYSIS OF UNAPPROPRIATED RETAINED EARNINGS PER BOOKS (line 24 above)

1 Balance at beginning of year	2,613,832.37	5 Distributions: (a) Cash	180,516.00
2 Net income per books	540,940.76	(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
		7 Total of lines 5 and 6	180,516.00
4 Total of lines 1, 2, and 3	3,154,773.13	8 Balance at end of year (line 4 less 7)	2,974,257.13

☆ U.S. GOVERNMENT PRINTING OFFICE (1969—O-337-081

Schedule 1

PORTLAND CEMENT CO. OF UTAH 87-0165650

COST OF PROCESSING

for the year ended March 31, 1970

Quarry:		
Labor	$ 69,189.36	
Supplies and maintenance	29,420.64	
Power	8,556.48	
Insurance	2,376.72	
Depreciation	32,253.89	
Property taxes	10,005.37	
Employee benefits	11,378.02	
General manufacturing costs applied	35,271.71	
Laboratory costs applied	17,346.08	
Electrical department costs applied	1,012.92	
Shop costs applied	3,539.87	
Profit-sharing plan contribution	1,253.50	
		$ 221,604.56
Hauling quarry rock		96,496.40
Raw grinding and blending:		
Labor	27,661.83	
High lime rock	95,918.12	
Slag	4,397.45	
Silica	29,043.15	
Supplies and maintenance	32,805.99	
Depreciation	138,666.44	
Power	70,288.27	
Employee benefits	4,551.21	
General manufacturing costs applied	51,808.34	
Laboratory costs applied	34,692.15	
Electrical costs applied	6,583.98	
Shop costs applied	16,814.40	
		513,231.33
Burning and cooling:		
Labor	120,073.60	
Fuel	328,432.39	
Supplies and maintenance	101,519.05	
Depreciation	108,941.02	
Power	47,492.07	
Employee benefits	19,747.29	
General manufacturing costs applied	91,882.88	
Laboratory costs applied	26,019.11	
Electrical department costs applied	29,881.15	
Shop costs applied	43,363.44	
		917,352.00
Forward		1,748,684.29

Schedule 1

PORTLAND CEMENT CO. OF UTAH 87-0165650

COST OF PROCESSING, Continued

Forward		$1,748,684.29
Finish grinding:		
Labor	$ 30,895.46	
Gypsum	64,923.15	
Grinding aids	12,504.58	
Supplies and maintenance	7,225.51	
Depreciation	33,090.73	
Power	60,789.85	
Employee benefits	5,084.40	
General manufacturing costs applied	24,985.24	
Laboratory costs applied	8,673.04	
Electrical department costs applied	7,090.44	
Shop costs applied	12,389.56	
		267,651.96
Cost of processing		$2,016,336.25

Schedule 7

PORTLAND CEMENT CO. OF UTAH 87-0165650

COMPUTATION OF DEPLETION ALLOWANCE ON CEMENT ROCK

for the year ended March 31, 1970

Gross sales of cement	$3,799,355.81	
Less cash discounts	164,622.74	
Net sales of cement	3,634,733.07	
Less sales of purchased cement	37,937.97	
Net sales of manufactured cement	3,596,795.10	
Less premium for bagged cement	30,913.55	
		$3,565,881.55
Cost of mining processes:		
Quarring	221,604.56	
Hauling quarry rock	96,496.40	
Raw grinding and blending	513,231.33	
	831,332.29	
Total cost of processing (Schedule 1)	2,016,336.25	
Ratio of mining process costs to total processing costs		41.23 %
Gross income from mining		1,470,212.98
Cost of mining processes		831,332.29
Net income from mining		$ 638,880.69
Depletion allowance: 15% of gross income from mining		$ 220,531.95
Limitation: 50% of net income from mining		$ 319,440.35

Note: This depletion computation is in accordance with the decision of the 19th Circuit Court of Appeals in the Ideal Basic Industries case, August 15, 1968. All "properly allocable" costs have been allocated.

POSTMARK DATE

07312177005

Form **1120** JUN 15 1971

Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1970 or other taxable year beginning Apr. 1, 1970, ending Marc. 31, 19 71

(PLEASE TYPE OR PRINT)

1970

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See page 7 of instructions.) 3240

Name: SC 87-0165650 FOR MAR 31 1971 DOS7
PORTLAND CEMENT COMPANY OF UTAH
Number: BOX 1469
City: SALT LAKE CITY UT 84110

D Employer Identification No. 87-0165650
E County in which located Salt Lake
F Enter total assets from line 14, column (D), Schedule L (See instruction R) $ 5,977,931.23

IMPORTANT—Fill in all applicable lines and schedules. If the lines on the schedules are not sufficient, see instruction N.

GROSS INCOME	1 Gross receipts or gross sales 3,591,698.61 Less: Returns and allowances 150,987.27		3,440,711.34
	2 Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)		2,059,351.42
	3 Gross profit		1,381,359.92
	4 Dividends (Schedule C)		30,190.40
	5 Interest on obligations of the United States and U.S. instrumentalities		61,433.03
	6 Other interest		55,576.40
	7 Gross rents		
	8 Gross royalties		
	9 Net gains (losses)—(separate Schedule D)		7,197.87
	10 Other income (attach schedule) Schedule 2		3,006.64
	11 TOTAL income—Add lines 3 through 10		1,538,764.26
DEDUCTIONS	12 Compensation of officers (Schedule E)		39,225.00
	13 Salaries and wages (not deducted elsewhere)		110,920.01
	14 Repairs (do not include capital expenditures)		
	15 Bad debts (Schedule F if reserve method is used)		2,347.18
	16 Rents		30,000.00
	17 Taxes (attach schedule) Schedule 3		36,430.14
	18 Interest		87,106.25
	19 Contributions (not over 5% of line 28 adjusted per instructions—attach schedule)		625.00
	20 Amortization (attach schedule)		3,094.20
	21 Depreciation (Schedule G)		17,290.30
	22 Depletion Schedules 7 and 8		195,962.29
	23 Advertising Excluding amounts included in Schedule 1		6,408.85
	24 Profit sharing, stock bonus, pension and annuity plans (see instructions)		9,179.10
	25 Other employee benefit plans (see instructions) Schedule 12		3,568.78
	26 Other deductions (attach schedule) Schedule 9		196,464.01
	27 TOTAL deductions on lines 12 through 26		738,621.11
	28 Taxable income before net operating loss deduction and special deductions (line 11 less line 27)		800,143.15
	29 Less: (a) Net operating loss deduction (see instructions—attach schedule)		
	(b) Special deductions (Schedule I)	26,027.67	26,027.67
	30 Taxable income (line 28 less line 29)		774,115.48
TAX	31 TOTAL TAX (Schedule J)		369,145.25
	32 Credits: (a) Tax paid (deposited) with Form 7004 application for extension (attach copy)		
	(b) Estimated tax—Overpayment from 1969 allowed as a credit 55,269.29		
	1970 estimated tax payments (deposits) 360,000.00		
	Less refund of 1970 estimated tax applied for on Form 4466 ( )	415,269.29	
	(c) Credit from regulated investment companies (attach Form 2439)		
	(d) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)		415,269.29
	33 TAX DUE (line 31 less line 32). See instruction G for depositary method of payment →		
	34 OVERPAYMENT (line 32 less line 31) →		46,124.04
	35 Enter amount of line 34 you want: Credited to 1971 estimated tax ▶ 46,124.04 Refunded ▶		

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than the taxpayer, his declaration is based on all information of which he has any knowledge.

CORPORATE SEAL

June 14 1971 (Date) — (Signature of officer) — President (Title)

6-2-71 (Date) — Lybrand, Ross Bros. & Montgomery, Salt Lake City, Utah 84111 (Individual or firm signature of preparer) (Address)

B-2

[Exhibit B-2]

Schedule J—TAX COMPUTATION

1 Taxable income (line 30, page 1)		774,115.48
2 Surtax exemption—Enter line 1 or $25,000, whichever is lesser. (Component members of a controlled group see page 6 of instructions and enter your surtax exemption or line 1, whichever is lesser)		25,000.00
3 Line 1 less line 2		749,115.48
4 (a) 22% of line 1	170,305.41	
(b) 26% of line 3	194,770.02	
(c) If multiple surtax exemption is elected under section 1562, enter 6% of line 2	1,500.00	366,575.43
5 (a) Income tax (line 4, or alternative tax from separate Schedule D, whichever is lesser) Alt.	365,124.61	
(b) Tax Surcharge—2½% of line 5(a) (Fiscal and short year corporations, see page 6 of instr.)	4,551.55	369,676.16
6 Foreign tax credit (attach Form 1118)		
7 Line 5 less line 6		369,676.16
8 Investment credit (attach Form 3468)		530.91
9 Line 7 less line 8		369,145.25
10 (a) Personal holding company tax (attach Schedule 1120 PH)		
(b) Tax Surcharge—2½% of line 10(a) (Fiscal and short year corporations, see page 6 of instr.)		
11 Tax from recomputing a prior year investment credit (attach Form 4255)		
12 Minimum tax on tax preference items (See page 6 of instructions). Check here ☒ if Form 4626 is attached		
13 Total tax—Add lines 9 through 12. Enter here and on line 31, page 1		369,145.25

Form 1120 (1970) **Schedule L—BALANCE SHEETS** Page 4

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash		633,366.42		1,429,782.63
2 Trade notes and accounts receivable	165,413.21		216,645.77	
(a) Less allowance for bad debts	3,989.74	161,423.47	7,039.50	209,606.27
3 Inventories		250,552.88		269,576.40
4 Gov't obligations: (a) U.S. and instrumentalities		1,153,261.26		389,843.75
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule) Sch. 11		91,735.60		78,780.45
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule) Quarry claims		41,728.56		41,728.56
9 Buildings and other fixed depreciable assets	6,345,126.14		6,415,895.58	
(a) Less accumulated depreciation	3,275,371.58	3,069,754.56	3,561,210.94	2,854,684.64
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)		10,286.00		10,286.00
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule) Sch. 11		252,865.91		693,642.53
14 Total assets		5,664,974.66		5,977,931.23
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable		134,994.05		220,283.52
16 Mtges., notes, bonds payable in less than 1 yr.		150,000.00		150,000.00
17 Other current liabilities (attach schedule) Sch. 11		95,189.28		97,082.26
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more		1,500,000.00		1,350,000.00
20 Other liabilities (attach schedule) Prov. for addl. income taxes		445,734.20		466,195.68
21 Capital stock: (a) Preferred stock				
(b) Common stock	379,900.00	379,900.00	379,900.00	379,900.00
22 Paid-in or capital surplus (attach reconciliation)		7,000.00		7,000.00
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated		2,974,257.13		3,307,469.77
25 Less cost of treasury stock		(22,100.00		( )
26 Total liabilities and stockholders' equity		5,664,974.66		5,977,931.23

Schedule M-1—RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

1 Net income per books	591,124.64	7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax	369,145.25	(a) Tax-exempt interest $	
3 Excess of capital losses over capital gains			
4 Taxable income not recorded on books this year (itemize)			
		8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (itemize)		(a) Depreciation $	
(a) Depreciation $		(b) Depletion $ 195,962.29	
(b) Depletion $		Def. fed. inc. tax 6.65	
		Utah franch. tax 33,419.24	
Schedule 14	69,261.44	9 Total of lines 7 and 8	229,388.18
6 Total of lines 1 through 5	1,029,531.33	10 Income (line 28, page 1)—line 6 less 9	800,143.15

Schedule M-2—ANALYSIS OF UNAPPROPRIATED RETAINED EARNINGS PER BOOKS (line 24 above)

1 Balance at beginning of year	2,974,257.13	5 Distributions: (a) Cash	257,912.00
2 Net income per books	591,124.64	(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
		7 Total of lines 5 and 6	257,912.00
4 Total of lines 1, 2, and 3	3,565,381.77	8 Balance at end of year (line 4 less 7)	3,307,469.77

Schedule 1
87-0165650

PORTLAND CEMENT CO. OF UTAH

COST OF PROCESSING

for the fiscal year ended March 31, 1971

Quarry:		
Labor	$ 74,146.86	
Supplies and maintenance	25,911.74	
Development costs	6,950.00	
Power	8,922.41	
Insurance	2,569.31	
Depreciation	33,600.11	
Property taxes	11,192.33	
Employee benefits	13,496.88	
General manufacturing costs applied	-36,950.07	
Laboratory costs applied	9,512.37	
Electrical department costs applied	794.75	
Shop costs applied	1,380.23	
Profit-sharing plan contribution	325.50	
		$ 225,752.56
Hauling Quarry Rock		88,758.45
Raw Grinding and Blending:		
Labor	25,131.40	
High lime rock	105,085.53	
Slag	3,038.76	
Silica	26,780.62	
Supplies and maintenance	64,327.12	
Depreciation	123,176.04	
Power	66,062.26	
Employee benefits	4,574.26	
General manufacturing costs applied	46,090.88	
Laboratory costs applied	32,342.06	
Electrical department costs applied	15,079.88	
Shop costs applied	12,033.52	
		523,722.33
Burning and Cooling:		
Labor	124,075.66	
Fuel	314,906.58	
Supplies and maintenance	65,518.48	
Depreciation	103,509.29	
Power	44,636.66	
Employee benefits	22,577.62	
General manufacturing costs applied	91,939.33	
Laboratory costs applied	27,585.88	
Electrical department costs applied	18,060.19	
Shop costs applied	39,740.28	
		852,549.97

Schedule 1
Sheet 2

COST OF PROCESSING, Continued

Finish Grinding:		
Labor	$ 35,831.55	
Gypsum	66,469.31	
Grinding aid	15,402.69	
Supplies and maintenance	25,874.13	
Depreciation	28,638.73	
Power	57,134.91	
Employee benefits	6,516.90	
General manufacturing costs applied	26,032.00	
Laboratory costs applied	25,683.40	
Electrical department costs applied	11,391.42	
Shop costs applied	22,564.14	
		$ 321,539.18
Cost of Processing		$2,012,322.49

Federal
Schedule 7

PORTLAND CEMENT CO. OF UTAH

COMPUTATION OF DEPLETION ALLOWANCE ON CEMENT ROCK

for the fiscal year ended March 31, 1971

Gross sales of cement	$3,591,698.61	
Less cash discounts	150,987.27	
Net sales of cement	3,440,711.34	
Less sales of purchased cement	46,113.57	
Net sales of manufactured cement	3,394,597.77	
Less premium for bagged cement	35,906.78	
		$3,358,690.99
Cost of mining processes:		
Quarrying	225,752.56	
Hauling quarry rock	88,758.45	
Raw grinding and blending	523,722.33	
	838,233.34	
Total cost of processing (Schedule 1)	$2,012,327.49	
Ratio of mining process costs to total processing costs		41.66%
Gross income from mining		1,399,230.67
Cost of mining processes		838,233.34
Net income from mining		$ 560,997.33
Depletion allowance:		
14% of gross income from mining		$ 195,892.29
Limitation:		
50% of net income from mining		$ 280,498.67

Note: This depletion computation is in accordance with the decision of the Tenth Circuit Court of Appeals in the Ideal Basic Industries case, August 15, 1968. All "properly allocable" costs have been allocated.

SELECTED 876082 53 (56)

Form **1120** — Department of the Treasury, Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 1971 or other taxable year beginning APR 1, 1971, ending Mar. 31, 19 72

(PLEASE TYPE OR PRINT)

1971

POSTMARK DATE

JUN 14 1972

Check if a—
A Consolidated return ☐
B Personal Holding Co. ☐
C Business Code No. (See page 7 of instructions.) 3240

Name: SC 87-0165650 FOR MAR 31,1972 087 M
PORTLAND CEMENT COMPANY OF UTAH
Number: BOX 1
City: SALT LAKE CITY UT 84110

D Employer Identification No. 87-0165650
E County in which located: Salt Lake
F Enter total assets from line 14, column (D), Schedule L. (See instructions for IR) $ 6,199,880.69

IMPORTANT—Fill in all applicable lines and schedules. If the lines on the schedules are not sufficient, see instruction H.

GROSS INCOME	1 Gross receipts or gross sales 4,891,897.56 Less: Returns and allowances 191,778.89		1	4,700,118.67
	2 Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)		2	2,431,229.49
	3 Gross profit		3	2,268,889.18
	4 Dividends (Schedule C)		4	21,190.40
	5 Interest on obligations of the United States and U.S. instrumentalities		5	27,850.77
	6 Other interest		6	92,583.59
	7 Gross rents		7	
	8 Gross royalties		8	
	9 (a) Net capital gains—(separate Schedule D) 5,912.01		9(a)	X 5,937.50
	(b) Ordinary gain or (loss) from Part II, Form 4797 (attach Form 4797)		9(b)	(25.49)
	10 Other income (see instructions—attach schedule)		10	3,113.18
	11 TOTAL income—Add lines 3 through 10		11	2,419,539.13
DEDUCTIONS	12 Compensation of officers (Schedule E)		12	40,200.00
	13 Salaries and wages (not deducted elsewhere)		13	120,892.76
	14 Repairs (see instructions)		14	
	15 Bad debts (Schedule F if reserve method is used)		15	1,599.21
	16 Rents		16	30,000.00
	17 Taxes (attach schedule) Schedule 3		17	36,629.41
	18 Interest		18	223,283.19
	19 Contributions (not over 5% of line 28 adjusted per instructions—attach schedule) Sch. 4		19	1,680.00
	20 Amortization (attach schedule) Schedule 5		20	3,094.20
	21 Depreciation (Schedule G)		21	17,422.27
	22 Depletion Schedules 7 and 8		22	187,539.90
	23 Advertising		23	6,108.64
	24 Pension, profit-sharing, etc. plans (see instructions) Excluding amts included in Sch. 1		24	13,864.06
	25 Employee benefit programs (see instructions) Schedule 12		25	4,614.93
	26 Other deductions (attach schedule) Schedule 9		26	214,837.92
	27 TOTAL deductions—Add lines 12 through 26		27	901,766.49
	28 Taxable income before net operating loss deduction and special deductions (line 11 less line 27)		28	1,517,772.64
	29 Less: (a) Net operating loss deduction (see instructions—attach schedule) 29(a)			
	(b) Special deductions (Schedule I) 29(b) 19,061.84			19,061.84
	30 Taxable income (line 28 less line 29)		30	1,498,710.80
TAX	31 TOTAL TAX (Schedule J)		31	709,268.68
	32 Credits: (a) Overpayment from 1970 allowed as a credit 46,124.04			
	(b) 1971 estimated tax payments 675,000.00			
	(c) Less refund of 1971 estimated tax applied for on Form 4466 ( ) 721,124.04			
	(d) Tax deposited with Form 7004 (attach copy)			
	(e) Tax deposited with Form 7005 (attach copy)			
	(f) Credit from regulated investment companies (attach Form 2439)			
	(g) U.S. tax on special fuels, nonhighway gas and lubricating oil (attach Form 4136)			721,124.04
	33 TAX DUE (line 31 less line 32). See instruction G for depositary method of payment		33	
	34 OVERPAYMENT (line 32 less line 31)		34	12,855.36
	35 Enter amount of line 34 you want: Credited to 1972 estimated tax ▶ 12,855.36 Refunded ▶		35	

RECEIVED JUL 16 1972 Internal Revenue Service Ogden, Utah

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than the taxpayer, his declaration is based on all information of which he has any knowledge.

The Internal Revenue Service does not require a seal on this form, but if one is used, please place it here.

6-14-72 Date — Signature of officer — Secretary Title

6-7-72 Date — Lybrand, Ross Bros. & Montgomery, Salt Lake City, Utah 841 — Signature of individual or firm preparing the return — Address

C-3

Schedule J—TAX COMPUTATION

1 Taxable income (line 30, page 1)		1,498,710.80
2 Surtax exemption—Enter line 1 or $25,000, whichever is lesser. (Component members of a controlled group—see page 6 of instructions and enter your surtax exemption or line 1, whichever is lesser)		25,000.00
3 Line 1 less line 2		1,473,710.80
4 (a) 22% of line 1	329,716.38	
(b) 26% of line 3	383,164.81	
(c) If multiple surtax exemption is elected under section 1562, enter 6% of line 2	1,500.00	714,381.19
5 Income tax (line 4, or alternative tax from separate Schedule D, whichever is lesser)		713,312.44 Alt.
6 Foreign tax credit (attach Form 1118)		
7 Line 5 less line 6		713,312.44
8 Investment credit (attach Form 3468)		5,043.76
9 Line 7 less line 8		708,268.68
10 Personal holding company tax (attach Schedule 1120 PH)		
11 Tax from recomputing a prior year investment credit (attach Form 4255)		
12 Minimum tax on tax preference items (see page 6 of instructions). Check here ☒ if Form 4626 is attached		
13 Total tax—Add lines 9 through 12. Enter here and on line 31, page 1		708,268.68

Form 1120 (1971) **Schedule L—BALANCE SHEETS** Page 4

ASSETS	Beginning of taxable year (A) Amount	Beginning of taxable year (B) Total	End of taxable year (C) Amount	End of taxable year (D) Total
1 Cash		1,429,782.63		948,776.84
2 Trade notes and accounts receivable	216,645.77		334,674.46	
(a) Less allowance for bad debts	7,039.50	209,606.27	9,538.22	325,136.24
3 Inventories		269,576.40		251,413.00
4 Gov't obligations: (a) U.S. and instrumentalities		389,843.75		195,031.25
(b) State, subdivisions thereof, etc.				
5 Other current assets (attach schedule) Sch. 11		78,780.45		47,726.41
6 Loans to stockholders				
7 Mortgage and real estate loans				
8 Other investments (attach schedule) Quarry claims		41,728.56		41,728.56
9 Buildings and other fixed depreciable assets	6,415,895.58		6,070,097.46	
(a) Less accumulated depreciation	3,561,210.94	2,854,684.64	3,430,802.21	2,639,295.25
10 Depletable assets				
(a) Less accumulated depletion				
11 Land (net of any amortization)		10,286.00		10,286.00
12 Intangible assets (amortizable only)				
(a) Less accumulated amortization				
13 Other assets (attach schedule)		693,642.53		1,740,487.14
14 Total assets		5,977,931.23		6,199,880.69
LIABILITIES AND STOCKHOLDERS' EQUITY				
15 Accounts payable		220,283.52		198,523.29
16 Mtges., notes, bonds payable in less than 1 yr.		150,000.00		150,000.00
17 Other current liabilities (attach schedule) Sch. 11		97,082.26		103,944.65
18 Loans from stockholders				
19 Mtges., notes, bonds payable in 1 yr. or more		1,350,000.00		1,200,000.00
20 Other liabilities (attach schedule) Add fed. income taxes		466,195.68		92,725.00
21 Capital stock: (a) Preferred stock				
(b) Common stock	379,900.00	379,900.00	379,900.00	379,900.00
22 Paid-in or capital surplus (attach reconciliation)		7,000.00		7,000.00
23 Retained earnings—Appropriated (attach sch.)				
24 Retained earnings—Unappropriated		3,307,469.77		4,067,787.75
25 Less cost of treasury stock		( )		( )
26 Total liabilities and stockholders' equity		5,977,931.23		6,199,880.69

Schedule M-1—RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN

1 Net income per books	1,018,649.98	7 Income recorded on books this year not included in this return (itemize)	
2 Federal income tax	708,268.68	(a) Tax-exempt interest $	
3 Excess of capital losses over capital gains		Equity in subsidiary 2,115.78; Fed. inc. tax refund 3,259.46	5,375.24
4 Taxable income not recorded on books this year (itemize)		8 Deductions in this tax return not charged against book income this year (itemize)	
5 Expenses recorded on books this year not deducted in this return (itemize)		(a) Depreciation $	
(a) Depreciation $		(b) Depletion $187,539.90	
(b) Depletion $		Sch. 14 178,008.72	365,548.62
Sch. 14 - $161,777.84	161,777.84	9 Total of lines 7 and 8	370,923.86
6 Total of lines 1 through 5	1,888,696.50	10 Income (line 28, page 1)—line 6 less 9	1,517,772.64

Schedule M-2—ANALYSIS OF UNAPPROPRIATED RETAINED EARNINGS PER BOOKS (line 24 above)

1 Balance at beginning of year	3,307,469.77	5 Distributions: (a) Cash	258,332.00
2 Net income per books	1,018,649.98	(b) Stock	
3 Other increases (itemize)		(c) Property	
		6 Other decreases (itemize)	
		7 Total of lines 5 and 6	258,332.00
4 Total of lines 1, 2, and 3	4,326,119.75	8 Balance at end of year (line 4 less 7)	4,067,787.75

Schedule 1
87-0165650

PORTLAND CEMENT CO. OF UTAH

COST OF PROCESSING

Fiscal year ended March 31, 1972

Quarry:		
Labor	$ 80,644.51	
Supplies and maintenance	57,434.48	
Power	9,036.32	
Insurance	5,865.09	
Depreication	27,725.91	
Property taxes	11,064.49	
Employee benefits	16,078.53	
General manufacturing costs applied	39,843.78	
Laboratory costs applied	13,886.87	
Electrical department costs applied	1,259.55	
Shop costs applied	2,634.95	
Profit sharing plan contribution	1,566.04	
		$ 267,040.52
Hauling quarry rock		120,195.90
Raw grinding and blending:		
Labor	30,717.20	
High lime rock	84,085.55	
Slag	4,171.26	
Silica	23,752.99	
Supplies and maintenance	61,647.48	
Depreciation	110,945.96	
Power	78,513.66	
Employee benefits	6,120.49	
General manufacturing costs applied	37,868.35	
Laboratory costs applied	40,592.40	
Electrical department costs applied	18,635.57	
Shop costs applied	17,541.83	
		514,592.74
Burning and cooling:		
Labor	151,9[illegible]	
Fuel	467,479.97	
Supplies and maintenance	127,917.23	
Depreciation	97,852.12	
Power	53,049.77	
Employee benefits	30,308.30	
General manufacturing costs applied	95,423.22	
Laboratory costs applied	20,296.20	
Electrical department costs applied	35,811.22	
Shop costs applied	45,728.44	
		1,125,823.86
Forward		2,027,653.02

Portland Cement Co. of Utah

Schedule 1
Sheet 2

Forward		$2,027,653.02
Finish grinding:		
Labor	$ 39,964.91	
Gypsum	84,194.53	
Grinding aid	2,264.21	
Supplies and maintenance	11,229.84	
Depreciation	27,557.26	
Power	67,903.70	
Employee benefits	7,969.23	
General manufacturing costs applied	25,603.83	
Laboratory costs applied	32,046.63	
Electrical department costs applied	8,988.59	
Shop costs applied	17,100.92	
		$ 324,823.65
Cost of processing		$2,352,476.67

Schedule 7
87-0165650

PORTLAND CEMENT CO. OF UTAH

PERCENTAGE DEPLETION ON CEMENT ROCK

Fiscal year ended March 31, 1972

Own quarry materials / Total raw materials = 81.56%			
Net sales of manufactured cement (Sheet 2)	4,655,431.33	x 81.56% =	$3,796,969.77
Eliminate from the computation:			
Storing and shipping expenses	228,744.12	x 81.56% =	186,563.70
Selling expenses	72,190.48	x 81.56% =	58,878.56
Adjusted gross receipts from sale of bulk cement			$3,551,527.51
Computation of gross income from mining:			
Quarry costs			$ 267,040.52
Hauling quarry rock			120,195.90
Grinding and blending (exclusive of purchase of raw materials)	402,582.94	x 81.56% =	328,346.65
Total pre-kiln costs (exclusive of purchased raw materials and costs of processing them)			715,583.07
Burning and cooling	1,125,823.86	x 81.56% =	918,221.89
Finish grinding	324,823.65	x 81.56% =	264,926.17
Total processing costs (exclusive of purchased raw materials and costs of processing them)			$1,898,731.13
715,583.07 divided by 1,898,731.13 = 37.69%			
Adjusted gross receipts			$3,551,527.51
Costs percentage			37.69%
Gross income from mining			1,338,570.71
Depletion rate			14%
Depletion allowance			$ 187,399.90
Computation of limitation:			
Gross income from mining			$1,338,570.71
Less total pre-kiln costs			(715,583.07)
Less indirect costs allocable to mining (Sheet 2)			(113,472.31)
Net income from mining			509,515.33
			50%
Limitation			$ 254,757.67

rtland Cement Co. of Utah

Schedule 7
Sheet 2

Computation of Net Sales of Manufactured Cement

Gross sales (no empty bag sales included)	$4,891,897.56
Less cash discounts	(191,778.89)
Less sales of purchased cement	(44,687.34)
Net sales of manufactured cement	$4,655,431.33

Allocation of General and Administrative Expenses and Interest to Mining

Quarry costs	$ 267,040.52
Hauling quarry rock	120,195.90
Grinding and blending (including cost of raw materials purchased)	514,592.74
Burning and cooling	1,125,823.86
Finish grinding	324,823.65
Storing and shipping expenses (no bad costs included)	228,744.12
Selling expenses	72,190.48
Total costs other than general and administrative and interest expenses	$2,653,411.27

Total pre-kiln costs (Sheet 1) 715,583.07 = 26.97%
Total costs other than general and administrative and interest 2,653,411.27

Indirect costs (general and administrative and interest expense)	$ 420,735.30
Percentage allocable to mining	26.97%
Allocable to mining	$ 113,472.31

[1] **UNITED STATES TAX COURT**

DOCKET NO. 6306-73

PORTLAND CEMENT COMPANY OF UTAH PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE RESPONDENT

TRANSCRIPT OF PROCEEDINGS
(January 20, 1975)

* * * * *

[2]

* * * * *

MR. FREED: Your Honor, we have a Stipulation of Facts. May I file that before opening statements?

THE COURT: Would you please?

THE CLERK: The last exhibit number is E-5.

THE COURT: Yes, the Stipulation of Facts and the exhibits attached are received in evidence.

MR. FULLER: If the Court please, with respect to one item on the exhibit, number 28, the last item—

THE COURT: Oh, well then—

[3] MR. FREED: He's just going to explain something, Your Honor. I accede to it. It's—

THE COURT: Well, I thought you said the exhibits ran from 1-A through E-5.

MR. FREED: Paragraph 28, I think he's referring to.

THE COURT: Oh. All right.

MR. FULLER: I'm referring to paragraph 28, the last paragraph of the exhibit.

THE COURT: All right. I thought you said exhibit. All right. You may proceed.

MR. FULLER: We'd like to make a correction to it and I understand it's satisfactory with counsel. The exhibit

referred to—actually it covers one of the contested issues of the matter that has been resolved. There was a $2,734.00 customer entertainment expense item and the government graciously conceded that item to us, and it is the intent of paragraph 28 to cover it.

THE COURT: I see.

MR. FULLER: In the deficiency notice and in our tax return, we have two other items that cover travel and entertainment, and this particular item that's embodied in the figure of $11,471.58 was really listed under customer entertainment, and we need that correction for the record. If that's satisfactory.

MR. FREED: Respondent agrees.

THE COURT: Then it's so stipulated, gentlemen.

* * * * *

[12]

* * * * *

MR. FULLER: The only other thing I'd like to do at this time, and I think it would help the Court, we have a little pamphlet that is put out by the Portland Cement Association called "The Making of Portland Cement". I've showed it to counsel and it would—I think it would be well to mark it as an exhibit and the Court could have it for reference.

THE COURT: You have no objection, I assume? As an exhibit—as petitioner's exhibit?

MR. FREED: No. I—that I have no objection. I believe the offer will be limited to indicate that the flow chart does not track entirely the petitioner's cement making process but substantially it's correct.

MR. FULLER: Yes, there are slight variations in our stipulation.

THE COURT: All right. It may be received in evidence.

THE CLERK: Exhibit 6 so marked.

* * * * *

[16]

* * * * *

THE CLERK: Petitioner's Exhibit 7 marked for identification.

MR. FULLER: If the Court please, this exhibit has been prepared and it has been shown to counsel for the respondent and he has a copy. I understand that he will present his case with his own exhibit as an aid and we would offer Exhibit 7 as representing the petitioner's computation in this case of its depletion allowance.

MR. FREED: I have no objection, Your Honor.

THE COURT: It'll be received as Petitioner's Exhibit.

THE CLERK: 7.

THE COURT: Thank you.

ASHBY SNOW DECKER,

called as a witness, having been duly sworn, took the stand and testified as follows:

DIRECT EXAMINATION

BY MR. FULLER:

Q What is your occupation, Mr. Decker:

A I'm vice president and secretary of the Portland Cement Company of Utah.

Q And for how long have you held that position?

A I've held that position since approximately 1962.

[17] Q And have you been employed with the company at all times since 1962?

A Yes I have.

Q With respect to your qualifications in a professional capacity, could you tell the Court basically your schooling background.

A I have a Bachelor's Degree in accounting from the University of Utah. I'm a Certified Public Accountant in the state of Utah. Work background—I've served two

years in the U.S. Air Force as an accounting officer. I've worked with the public accounting firm of Lincoln G. Kelly & Co., and since 1959 I've been employed by the Portland Cement Company of Utah, first as Comptroller and then as vice president and secretary.

Q And in this position since 1959, have you at all times had control and possession of the books and records of the company?

A Yes, I have.

Q Mr. Decker, we have had marked Exhibit No. 7 and do you have a copy of that exhibit in your possession?

A Yes I do.

Q And just in a general way, what does Exhibit 7 show? What is its purpose?

A Exhibit 7 shows the computation of the percentage depletion allowance to which I feel Portland [18] Cement Company of Utah is entitled for the fiscal years ended March 31st 1970, '71 and '72.

Q So this exhibit is made of three sheets stapled together, is that correct?

A That is right.

Q Now is there any particular method or formula that you have followed or attempted to follow in making this computation?

A Yes. The method I followed in making this computation is using the proportionate profits method as set forth in the 10th Circuit Court of Appeals decision in U.S. vs. Ideal Basic Industries, just as literally as I can read it and follow it.

Q And what are the first steps under the proportionate profits formula that one must follow?

A Basically, you have to determine the percentage relationship between mining costs and total manufacturing cost. The processes as shown on this exhibit, which are included in the mining processes, are quarry operation—

Q Let's take 1970 as a typical year and follow it through just briefly for the Court.

A All right. In the fiscal year ending March 31st, 1970, we had total costs at our quarry $221,604.56, all of which is classed as mining cost.

Q All right.

[19] A The next item is the hauling cost. This is the cost of transporting the crushed one inch minus material from the quarry to the cement plant at a cost of $96,496.40. This also is classified as—entirely as mining cost. The next item is raw grinding and blending. The total cost there being $383,872.61. This represents the cost of unloading the raw materials from the quarry, handling them into feed bins, grinding them in the rod peb mill, pumping it into the slurry tanks and storing it there for introduction to the kiln. That cost I have split between mining and non-mining because at this stage of the process, we do add some purchased materials. And what I have done is to take the total raw materials used and relate that to the purchased materials used to arrive at a percentage, and that percentage being the tonnage of purchased materials used, I have multiplied times the total raw grinding and blending cost and shown that as non-mining cost. In other words, the cost of raw grinding and blending the purchased materials I'm showing as non-mining costs in this formula in this year being $79,346.47. The balance—

THE COURT: $79,000.00 is the—

THE WITNESS: Non-mining portion of the raw grinding and blending costs.

THE COURT: All right.

[20] MR. FULLER: And this would be the portion of the total cost in that department that you have allocated then to the purchased materials.

A This is correct. And the next item in the computation—

THE COURT: $79,000.00 some odd hundred.

THE WITNESS: Yes, sir.

THE COURT: Is the purchased materials?

THE WITNESS: That's the cost of grinding and blending the purchased materials.

THE COURT: All right.

THE WITNESS: The next item is the cost of the purchased materials themselves—

THE COURT: Oh.

THE WITNESS: $129,358.72. And that, of course, I've also classified as non-mining cost.

MR. FULLER: Did you, in arriving at the allocation you made, why did you not put the blending of and the grinding of the purchased materials in the mining category, along with the blending and mining of our own materials?

A Well, I felt that the tonnage was significant enough that it couldn't be termed incidental. In trying to follow literally the decision in Ideal Basic Industries, they included the cost there of grinding and blending [21] the purchased materials as part of mining costs because they ruled that they were incidental to the grinding and blending of the taxpayer's own materials. In our case, I felt that it was of sufficient tonnage that it probably could not be considered as incidental and therefore I excluded it from mining cost.

Q And by excluding it, did that favor us or hurt our percentage depletion?

A It reduces the percentage depletion.

Q All right. Then similarly, you took purchased additives and put those in the non-mining costs?

A That's correct.

Q All right. Take your next categories.

A Burning and cooling is the next manufacturing process. This involves introducing the slurry into the kiln, burning it to a clinker and, of course, cooling the clinker and disposing of the gasses and the fumes and the dust from the kiln. The total cost of that process in this year being $917,352.00, all of which I've classified as non-mining. And the final process in manufacturing Portland Cement is finish grinding, which involves adding four percent, approximately, gypsum to the clinker and grinding it in a ball mill into finished cement. The total cost of that

process in this year being $267,651.96, and all of that I have [22] classified as non-mining costs.

Q Now in segregating the mining and the non-mining costs to this point, how do these types of costs differ from general costs that we might have in cement making operations?

A Well, these are direct manufacturing costs incurred in these manufacturing processes.

Q Okay. Now, after sorting these direct costs into mining and non-mining categories, what did you next do?

A The next was to arrive at a percentage by taking the total mining cost and dividing that total by the total manufacturing cost, which results in a percentage in the particular year that we're looking at of 30.88 percent. This represents the relationship between mining costs and total manufacturing costs.

Q Now let me back up a little bit at this point. In arriving at these direct costs, at what stage in the total operations did you terminate the cost items that went into this percentage?

A At bulk cement.

Q At bulk cement.

A In other words, the total cost of manufacturing bulk cement is what's included in this computation.

Q And for the record, what is bulk cement and [23] where in the stage of activities do we arrive at bulk cement?

A Bulk cement is a very finely ground material, a very complex chemical composition. I couldn't give you a chemical formula for it. It occurs at the end of the finish grinding process after the clinker mixed with gypsum is ground to the required fineness, passes through some specialized equipment known as an air separater and is blown into storage silos for storage. At that point, you have bulk cement.

Q And is bulk cement saleable in that form?

A Yes it is.

Q And so that the Court will understand when bulk cement is sold, is it put in any kind of containers or just what is done with it when a customer takes it?

A It's loaded directly from storage silos into either bulk tanker trucks or bulk railroad cars.

Q All right. Now, does Portland Cement Company sell any of its cement in any form other than in this bulk type transfer?

A Yes. We sell some cement in paper bags.

Q And is this a process that comes before or after the bulk cement stage?

A It's after the bulk cement stage.

Q And what is done with the cement in the process [24] line to get it into the bags?

A It's simply taken from the storage silos, run into a bin above a bagging machine and it passes through the bagging machine and is placed in paper bags.

Q For the years involved, Mr. Decker, could you tell the Court the relative percentages of bag cement as compared with bulk cement that the company sells?

A Yes. In the fiscal year ended March 31st, 1970, seven percent of our cement was sold in bags. Fiscal year ended March 31st, 1971, eight percent was sold in bags and in the fiscal year ended March 31st, 1972, six point five percent was sold in bags.

Q Subsequent to the bulk cement stage of production, I take it there are other costs incurred in this total operation for the years involved.

A Yes.

Q Is that correct?

A Yes.

Q And does the company carry a category for storing, shipping and bagging costs?

A Yes. We just call it storing and shipping expense but included in that would be the costs of bagging.

Q And do you maintain records on the cost of bags?

A Yes.

Q And do you maintain selling expense records?

[25] A Yes we do.

Q Now to this point in your formula, in your computation and arriving at the percentage of 30.88 percent, did any of those costs that I have just now enumerated go into the direct costs?

A No. Those costs have all been excluded entirely from the computation.

Q And in this respect, have you attempted to follow the Ideal Basic decision?

A Yes. The decision specifically states that that should be done.

Q All right. Let's move down your formula for the subject year 1970 and I'm going to next ask you what did you do with and how did you handle these indirect costs of running the business and explain to the Court what they are.

A The indirect costs are composed of such things as our general and administrative costs, costs of operating our general office, all of the various general costs that are necessary in operating a business that cannot be assigned to any one specific department. We've also included in indirect costs the dues paid to the Portland Cement Association. All of these indirect costs have been allocated between mining and non-mining, based on the percentage, 30.88 percent, which we arrived at by [26] dividing mining costs by total manufacturing cost.

Q And I think I should mention at this point for the Court's benefit that we have stipulated in our facts the handling of the contributions and the P.C.A. Association dues, and we have followed that in this formula, correct?

A (Witness nods his head, yes)

Q All right, then. After you have made your total allocation of costs in Exhibit 7, we get to the item of gross sales and would you tell the Court how you arrived at gross sales and how you related this to the Ideal Basic decision.

A Well, the gross sales figure is simply the total revenue realized from the sale of cement. Then we deducted from that the cash discounts which were allowed to customers for prompt payment of their invoices. We've also deducted out the sales of purchase cement. We buy small quantities of white cement which we don't manufacture ourselves and stock that in bags as a convenience to some of our customers who use it and, of course, that was deducted from the sales figure to arrive at net sales of manufactured cement.

Q Now the figure you show on Exhibit 7 for this year is $3,596,795.10.

A That is correct.

[27] Q Have you attempted to relate that figure to the sales of cement at the bulk stage?

A Yes. This would represent the sales of bulk cement itself without including any purchase cement, any containers or any of the cash discounts which were allowed.

Q Did you make some further deductions from those net sales?

A Yes. Then I eliminated from net sales of manufactured cement the direct storing and shipping expenses and also the direct selling expenses because those costs are to be eliminated entirely from the computation.

Q Now you mentioned earlier that you did not utilize them up in the direct mining and non-mining costs in arriving at your percentage and you've likewise, then, taken them out of the computation, out of the sales of cement. In taking them out as you have done, some two-thirds of the way down through the exhibit, what effect does that have either as a —to increase or to decrease the depletion allowance?

A Well that has the effect of decreasing the depletion allowance.

Q All right. Then when you get your final net sales figures as adjusted, you've applied the 30.88 percent, [28] correct?

A That is right.

Q And what does that give you?

A This gives, in this particular year, a figure of $1,039,886.62, which is the gross income from mining arrived at through this formula.

Q So from the formula, then, to reach back to the front stage of this operation, you get that figure.

A That is right.

Q And you've applied the depletion rate. Correct?

A That is correct.

Q And then what does that give you?

A This gives the depletion allowance which, of course, is subject to the net income limitation.

Q And your figure for that year was $155,982.99. So that the Court will be aware of what we have done, you have used a different depletion rate, that is fifteen percent in 1970, fourteen percent in '71 and '72.

A That is correct. That statutory rate was changed.

Q Right. Now insofar as the limitation is concerned, that is, under the tax law you're limited to a depletion allowance which cannot exceed fifty percent of your net income per month. You understand that.

A That is right. Yes.

[29] Q And how did you relate back to the figures that you arrived at in Exhibit 7 to get your depletion allowance?

A I started with the gross income from mining figure which I had computed above in this year being $1,039,886.62, and I deducted from that the total direct mining cost and indirect mining costs as computed at the beginning of this exhibit to arrive at net income from mining which, in this year, was $309,653.08. Then I applied the fifty percent limitation figure to arrive at the limitation of $154,826.54.

Q So that in this particular year the limitation gave a depletion allowance slightly less than could have been received had the limitation not been in effect.

A That is right.

Q And summarizing the other two years, the total allowable depletion in 1971 was what amount?

A The allowable depletion in that year was $127,145.42, also as the result of the limitation applying.

Q And what was the situation in 1972 for that fiscal year?

A In March 31st '72, the allowable depletion was $186,223.85. The limitation did not apply in that year.

Q Now, Mr. Decker, in going back—well, let's [30] just go back ten years. Let's start with 1960. Has the general method or manner of producing cement been substantially or materially changed in the company's process?

A No. It's the same basic process.

Q And if we took this same spread of years right through these three years involved, would the first product sold by the company, that is, the bulk cement—would that procedure have changed at all?

A No. Bulk cement has always been our first saleable product.

Q And what about the percentages of bag cement—have those percentages changed materially or have they varied materially over the years?

MR. FREED: Objection, Your Honor. The books and records would be the best evidence for that answer.

THE COURT: Well, I recognize that that is the best evidence but—what's your observation, Mr. Fuller? As to the objection?

MR. FULLER: I wasn't asking him a specific question. We're more concerned with the general processes of the company and the general manner of selling to show a continuity or a similarity.

THE COURT: And your question was what, again?

MR. FULLER: As to the extent to which the [31] volume of bag sales has varied over the years. He has previously testified, I think, to figures of—well ranging between six and eight percent.

MR. FREED: Your Honor, if he has refreshed his recollection recently I withdraw my objection.

THE COURT: Is that right? I mean, Mr. Decker, have you recently checked these figures out?

THE WITNESS: I don't have the specific figures with me—the exact figures—

THE COURT: no, that—

THE WITNESS: But I know that it varied between six and ten percent.

THE COURT: All right. I'll overrule the objection then.

MR. FULLER: One thing I should clarify, Mr. Decker. There may be a discrepancy between the figures indicated on Exhibit 7 and those which I anticipate will show on the respondent's figures in arriving at gross sales, relating to the cost of bags. So that the record is straight, would you explain how the cost of bags is treated, accountingwise, in this operation?

A Yes. The bookkeeping method that has always been followed in the company since I've been associated with it is to take the cost of the empty bags when they are—at the time they are purchased from this bag manufacturer [32] and debit them all to them bag inventory account. Then at the time bags of cement are sold, the cost of the bag is credited to the bag inventory account so that it never is included in the sales figure at all on the records of the company.

Q In summary, then, Mr. Decker, I take it from your testimony that you have read the Ideal Basic Industry decision.

A Yes I have.

Q And you have—you're cognizant of the specific items referred to in the decision?

A Yes.

Q And from an accounting standpoint, have you attempted to follow that decision literally in Exhibit 7?

A Yes I have.

MR. FULLER: You may question the witness.

CROSS EXAMINATION

BY MR. FREED:

Q Mr. Decker, you refer to this white cement in bags—isn't it true that those sales of bag cement are not in controversy between the parties—we've stipulated the treatment of those?

A Not so far as I know.

Q Let me call your attention to—

THE COURT: Well, Mr. Fuller'd be better able to—[33] is that right, Mr. Fuller?

MR. FULLER: Yes. I don't think that's in controversy at all.

THE COURT: All right.

MR. FREED: Mr. Decker, you referred to bulk cement as being a stage in the process—what is there different about bulk cement as opposed to the cement that you manufacture and put in bags?

A It's the same cement. It's just in a bag.

Q And the bulk cement you put in a big bag, in other words, a truck, and the bag cement you put in a small bag weighing 94 pounds, is that correct?

A It contains 94 pounds of cement, yes.

Q Referring to your testimony about the figure that you have used as gross sales on Exhibit 7—

A Yes?

Q Of what is that comprised? I'm directing you particularly to the bag cement—the sales of bag cement that you manufacture.

A Well, as I tried to explain that, our sales figure just simply includes the sale of the cement itself without the empty bag.

Q Now this $3,799,355.81—and this question holds true for all three years—is that the actual receipts from your customers?

[34] A Oh, no. The actual receipts from the customers could include several other items. And, of course, is less than that because of cash discounts.

Q Cash discounts—well, let me start this way. You have told us about an item called bagged premium or premium for bag cement?

A Yes.

Q Now could you explain what that is?

A Well that is the additional price which we charge for cement sold in bags as compared with cement sold in bulk.

Q Now is that figure reflected in your gross sales figure for each year?

A Part of it is. The part of it in excess of the cost of the empty bag itself.

Q So you have included in your gross sales a figure which is attributable to a sale of a bag of cement.

A The sale of the cement contained in the bag, yes. Without the bag itself. Um hum. That's right.

Q And you charge more because the product is bagged.

A Yes.

Q And so how—tell me, how does that fit with your theory that bulk cement is the cutoff point? Aren't [35] you increasing your depletion allowance by increasing your gross sales for an item attributable to bag cement?

A I guess it boils down to a matter of definition. The cement is identical. It is bulk cement. Whether it's sold in a bag or whether it's loaded into a railroad car or truck in bulk. The cement—in other words, what I'm saying is the cement contained in that bag is bulk cement but it is sold in a bag.

Q Could you give us a hypothetical—for example, how many bags would you derive from a barrel of cement?

A There are four bags to the barrel of cement.

Q Four bags to the barrel. Approximately what would a barrel of cement be sold for? $4.50, roughly?

A I really can't tell you that from memory. Since these years we've—the whole industry has changed to billing in terms of hundredweights rather than barrels and I could tell you our current price in hundredweights but not in barrels.

Q May the witness have Exhibit B-4? Would this refresh your recollection, Mr. Decker—turn to page 19 of Exhibit B-4. Would this be a convenient place to start net sales in 1970—$4.21 a barrel?

A It should be a close approximation—it would not be an exact figure because that's just simply taking the net sales figure and dividing it by the total [36] number of barrels shipped. And you see, that would include your white cement, as well as manufactured cement, although that's a very small proportion.

Q Well, may we assume—

A It would be in that neighborhood, yes.

Q May we assume that a barrel of bulk cement would sell for $4.00? If we assumed that, what, in your opinion, would be the price of a bag of cement?

A Assuming this is just a hypothetical computation, I would say in the neighborhood of $1.19 per bag.

Q $1.19 per bag. Now, using those figures—

THE COURT: Based on what figure per barrel? $4.21?

THE WITNESS: I'm basing it on $4.75 per barrel—

MR. FREED: Oh, I'm sorry. I thought—$4.75 a barrel?

A What I'm saying is that in a year in which the price of bulk cement was $4.21, I would guess that the price of bag cement would be around $4.75 per barrel.

Q A dollar—

A For four bags—at $4.75 for a barrel of cement sold in bags—four bags of cement.

Q Okay. Now using those figures, $4.75 for four bags of cement—

[37] A Right.

Q As opposed to $4.21 for a barrel?

A Right.

Q Now using those figures, can you relate that to your bag premium?

A Yes. That, of course, would mean a bag—the difference between the selling price of bulk and bag cement in this hypothetical example would be fifty four cents. Of that fifty four cents, the cost of the empty bags themselves would amount to oh, let's say roughly forty cents for the four bags. So the remaining difference, the fourteen cents, would be the bag premium. That would be the premium charged—

Q The bag premium, right.

A For the fact that it was sold in bags rather than in bulk.

Q Okay, fine. Now in the Year—fiscal year ending 1970 and I believe it would be true for all other years—you tell me if it's not—with respect to a purchaser of four bags of cement for a total price of $4.75, what amount would be included in your gross sales figure?

A Again, assuming that the cost of the empty bags was forty cents per barrel, then a figure of $4.35 would have been included in sales. That would be gross [38] sales before discounts.

Q Four dollars and thirty-five cents. Now how do you get that?

A I was assuming that bag cement was sold at a price of $4.75 per barrel.

Q That's what the purchaser paid you for it, $4.75 for the four bags?

A Right.

Q Okay. Now how much did you include in income, in your gross sales figure?

A In sales, $4.35.

Q Four dollars and thirty-five cents. So you collected forty cents from the customer that you do not have included in your gross sales figure?

A That's right. That was offset against the bag inven-

tory. There may have been other things included that the customer was billed for too, such as sales tax—

Q Yes, but for the purposes of our hypothetical—and this would be true in each of the three years?

A Yes.

Q Now, I notice in your computation, Petitioner's Exhibit 7, you have not eliminated from net sales of manufactured cement this forty cents relating to the cost of bags. And would just tell us briefly why that is?

A As I said before, I was trying to follow the Ideal [39] Basic Industries decision just as closely and as literally as possible. It made no mention that I could see in that decision of subtracting out the premium for bag cement, and yet I know for a fact that Ideal Cement Company does charge a premium for their bag cement.

Q Now, Mr. Decker, I'm talking about the cost of the bags themselves. Well, let help you. You didn't subtract it—

A I didn't subtract it 'cause it was never in there.

Q —because you never included it.

A The cost of the bag itself was never included in the sales figure, so it didn't need to be deducted out.

Q Thank you, very much. Could you tell us just briefly, after the finish grind occurs what happens to the cement?

A It goes into a bulk silo.

Q It goes into a bulk silo, and then from there what happens to the portion that you put in bags?

A It goes into a bin above the bagging machine for bagging.

Q Now, Mr. Decker, referring to Petitioner's Exhibit 7, and directing your attention to the computation that follows your net sales of manufactured cement, you have eliminated direct storing and shipping expenses and direct selling expenses. Why did you not attribute part of the [40] indirect expenses to those departments?

A Again trying to follow literally the Ideal Basic deci-

sion that it made no mention of making any such application. It simply said those expenses should be eliminated entirely from the computation—

Q Yes, Ideal Basic held that—

A It didn't say anything about attributing any portion of indirect costs to them before making that elimination.

Q As an accountant would you—you've testified, if I recall, that the indirect expenses are such things as general administrative expenses?

A Yes.

Q As an accountant would you attribute some of that expense to these cost centers?

A I don't think you can even make such a comparison, because the whole method and approach is, in my mind, is so contrary to any—

Q Well, do you—

A —normal accounting method.

Q —as a businessman—do you as a businessman make those—would you spread those costs between those activities?

A We do not, on our own financial statements make any allocation of indirect costs to storing and shipping and selling expenses, no. It does not appear on any of our [41] financial statements.

Q Are you referring to Exhibit D-4? Do you have it before you? Is that—

A D-4 or D-5?

Q D-4, I believe.

A This is the audit report that you are referring to?

Q Yes. Now this is prepared for you, is it not?

A Yes.

Q Do you play any part in indicating to Lybrand, Ross Brothers and Montgomery what schedules you would like to have in such a package?

A Oh yes, basically the financial statements are our financial statements. The CPA's are simply certifying them as being correct.

Q Would you look at Exhibit D-4 and turn to page 19.

A Yes.

Q Now, do you see there that the fourth line down—

A Yes.

Q —you have spread selling general and administrative expenses to the point of amount per barrel shipped. For each barrel you have computed a cost from those cost items.

A All right.

Q And yet you would think that—you allocate none of the indirect costs to—

A They have not been allocated on this statement, no. [42] The selling general and administrative expenses as shown on this statement are the direct costs of those departments. There has been no allocation made of the general and administrative or other indirect costs to those expenses, no.

Q And you do not think, as an accountant, that those departments should bear a proportionate part of the costs of the—such as the general administrative overhead?

A Well, you see this figure you are referring to is selling general and administrative expenses.

Q Yes.

A In other words, all of those items together are on one line.

Q Yes. But doesn't this statement recognize that as a charge against each barrel of cement?

A This statement does make the computation of dividing that total line item by the number of barrels shipped—

Q And if you—

A —to get an amount per barrel shipped, yes.

Q Yes, and if you make a charge against each barrel of cement that you produce, isn't it only logical that you

would spread the charge against these departments, storing, and shipping, and selling?

A I really don't follow you there—that isn't what this statement does or—

Q This statement does not—

[43] A —shows at all.

Q —I realize that. I'm asking you, as an accountant, whether you would?

A That depends entirely on the purpose for which you're making the computation preparing the statement.

Q Your storage costs, do they include the costs of storing the bulk cement?

A Yes.

MR. FREED: I have no further questions, Your Honor.

THE COURT: Any redirect, Mr. Fuller?

MR. FULLER: We have no further redirect.

THE COURT: Thank you, very much, Mr. Decker. You may step down.

(Witness excused)

MR. FULLER: We rest our case.

THE COURT: Mr. Freed, do you have a witness?

MR. FREED: Call Mr. Davitt, please.

THE CLERK: Raise you right hand. You do solemnly swear that the testimony you are about to give in the case will be the truth, the whole truth, and nothing but the truth so help you God?

THE WITNESS: I do.

THE CLERK: Please state your name and address for the record.

THE WITNESS: My name is William H. Davitt. [44] D-a-v-i-t-t.

MR. FREED: I'll ask Mr. Fuller if he would waive any foundation for my depletion computations?

MR. FULLER: I should make one statement to the Court. I have examined the computations that have been

made—I have studied them. They do, as I understand it, represent their theory of the case. We have, of course, a basic objection to them using them in that we understand they do not follow Ideal Basic and the Portland Cement of Utah case, which we would like to have as a continuing objection. Now, we have no objection to them showing what they're doing.

THE COURT: Well, you're entitled to you're continuing objection—

MR. FREED: I'm in no way limiting my offer. I'm offering this as evidence in the case. Shall I lay a foundation?

MR. FULLER: Why don't you do that. I would like to make a formal objection on the grounds that I've indicated. Go ahead.

WILLIAM H. DAVITT,

called as a witness, having been duly sworn, took the stand and testified as follows:

DIRECT EXAMINATION

BY MR. FREED:

Q Mr. Davitt, would you state your present employment, [45] please?

A I'm senior mining engineer with the Internal Revenue Service with the Office of the Assistant Commissioner Technical in the Engineering and Valuation branch in Washington, D.C.

Q And how long have you been in that position?

A I've been in that branch since 1959.

Q Could you tell the Court briefly your educational background?

A I'm a graduate mining engineer with a B.S. in mining engineering from Pennsylvania State University.

Q Could you describe briefly what duties you discharge in the course of your employment?

A Currently my immediate position is primarily a reviewer of other engineers and geologists in our branch,

who perform engineering assistance work in the administration of the Internal Revenue laws. On occasion I'm assigned cases to do the same type of work as necessary. This can involve many of the engineering issues, such as depletion computations, in "Brooling" letters, technical advice, litigation cases and things like that.

Q In the course of your duties have you become familiar with the proportionate profits method of computing depletion?

A Yes, I have.

Q Do you make depletion computations in the course of [46] your work?

A Yes, I do.

Q Have you ever made such computations in connection with the cement industry?

A Yes, I have.

Q Could you tell us the names of some of the cases in which you worked at our—litigated cases?

A Well, I worked on some of the computations involved [sic] in Standard Lime and Cement case in the Court of Claims, the Whitehall case in the Third Circuit, the Ideal case in the Tenth Circuit, and of course Portland of Utah case.

MR. FREED: May I have this marked, please?

THE CLERK: Respondent's Exhibit F, marked for identification.

MR. FREED: Mr. Davitt, I'll hand you what has been marked for identification as Respondent's Exhibit F, and ask if you can tell without testifying from the document, tell us what that is?

A That's the depletion computations I prepared for this case.

Q From what was it prepared?

A The information on that is primarily from the Stipulations of Fact that are presented.

Q Well, is there in fact any other source?

A Well, some of the figures on there are computations [47] which have resulted from information either from the tax return or from information given to me during the present preparation of the stipulations.

MR. FREED: I offer into evidence what has been marked as Respondent's Exhibit F, consisting of six pages, covering fiscal years ending March 31st, 1970, 1971, and 1972.

THE COURT: Mr. Fuller?

MR. FULLER: May I question the witness in aid of an objection?

THE COURT: Yes.

VOIR DIRE EXAMINATION

BY MR. FULLER:

Q Mr. Davitt, I have seen your computations, I am familiar with them. These purport to follow the proportionate profits formula. Would that be correct?

A That's correct.

Q Do these computations—well, first let me ask you this. You stated that your are familiar with the Ideal Basic Industry's case and computations that you made under it.

A Yes, I am.

Q And you are familiar with the decision, the accounting aspects?

A Yes, to some extent.

Q Do you represent that Exhibit F contains computations that accord or conform with Ideal Basic decision?

[48] MR. FREED: Your honor, I believe this is improper. It sounds like cross-examination.

THE COURT: No, I'll overrule the objection.

THE WITNESS: I'll put it this way. The computations correspond to my interpretation of the regulations and to the extent that the Ideal decision conflicts with the regulations then they do conflict with that.

MR. FULLER: We would object to their admissability on the grounds that they do not follow the established law of Ideal Basic Industries as set forth in this Circuit.

THE COURT: Well, I'm going to overrule the objection and receive it in evidence. It's received as Respondent's Exhibit F.

THE CLERK: Exhibit F.

MR. FULLER: And may we have a continuing objection to all of the exhibits and the testimony given in support of those portions that do conflict?

THE COURT: Yes, you may, Mr. Fuller, and you do.

DIRECT EXAMINATION (resumed)

BY MR. FREED:

Q Mr. Davitt, I'll hand you what has been received in evidence as Respondent's Exhibit F—would the Court like a copy of Exhibit F?

THE COURT: Yes, please.

MR. FREED: Mr. Davitt these computations follow [49] the same format and the theory for all three years, is that true?

A That's correct.

Q In preparing the computations what did you consider as a first marketable product?

A Finished cement in bulk and bagged form.

Q Why did you consider the finished cement in both bulk and bagged form as the first marketable product?

A Because that was the product that was sold to generate the sales figure that was used to allocate. In other words, I felt, as does the regulations, that bulk and bagged cement are one in the same product, it's only different volumes of the same product.

Q At what point in your computation have you assumed that mining ceases and manufacturing begins?

A Where the slurry is entered into the kiln.

Q Would you describe briefly for the Court your computation and how it was derived?

A Well, my computation, first of all involves the identification of the costs—the total costs necessary to generate a certain amount of income. In this case the amount of income is found on page 2. And that figure is $3,614,822.10. That sales figure—

Q Is that not $829.10.

A That's correct. The costs incurred by the taxpayer per the stipulation, to arrive at that figure are taken and [50] identified either as mining costs, non-mining costs, or allocable costs, which are the indirect costs—well, I'll discuss that in a minute. The mining costs are the costs incurred by the taxpayer up to the production of the slurry and are identified as quarry costs, two hundred and twenty-one thousand—

Q Mr. Davitt, the Court has a copy before it as does opposing counsel. We won't need to read the amounts.

A I'll just use the term. The quarry costs, the hauling of the rock, and the first entry of raw grind and blending costs are costs attributable to processing the taxpayer's mined materials.

Q Mr. Davitt, let me interrupt you at this point. Do you notice that on Petitioner's Exhibit 7, may I have that please, do you notice at this point that what you have allocated as mining at the raw grind and blend differs in a slight way from what the petitioner has. Could you account for that?

A Yes. The raw grinding and blending was a lump sum amount and an allocation had to be made between the mined material of the taxpayer and the purchase material of the taxpayer. This was done on a tonnage basis, and is reflected in a footnote on page 2. The computation there shows how I took the tonnage relationship to compute that percentage and allocated the total costs of three hundred and [51] eighty-three, eight seventy-two point sixty-one between mining and non-mining. The difference between my computation and the taxpayers computation, as far as I could see, only deals with the number of decimal points carried out and how far we carried it out.

Q Go ahead with your explanation. You were at the point of purchased additives.

A Okay. I allocated the raw grinding between—across the mined material and the purchased material, and then I included the purchased additives as a cost in non-mining, along with the burning and cooling activity, the finished grinding activity and the—in this case, since I used income as a result of selling the materials in bags after certain shipping and storing costs and bagging costs were incurred, I included those costs as direct non-mining costs, as well as the selling expense, since those costs were incurred by the taxpayer in the production of the income. I arrived at a direct cost ratio of point two seven five.

Q Excuse me, Mr. Davitt, would you express the fraction that produces that ratio?

A The direct cost ratio of point two seven five, is obtained by dividing the direct mining costs of the six hundred and twenty-two thousand six forty-two point forty-five by the total cost of two million, two hundred [52] sixty-three, six fifty-six point eighty-eight. Based upon that direct cost ratio, I then allocated, as a lump sum, the three hundred and forty-eight thousand, four hundred and sixty-six point forty-four of allocable costs, which included indirect costs. That figure allocated not—I mean as a result of that allocation, ninety-five thousand, eight hundred and twenty-eight point twenty-seven was allocated to mining. That indirect amount allocated to mining, when added to the direct costs of mining of six twenty-two, six forty-two point forty-five above, gives the total mining cost of seven hundred and eighteen thousand, four hundred and seventy point seventy-two dollars. Taking that and going over to the next page, I took a ratio of that total mining costs, seven hundred and eighteen, four seventy point seventy-two over the total cost, direct and allocable, of two million, six hundred and twelve, one twenty-two point thirty-two, to arrive at a ratio of point twenty-seven fifty. That ratio will be used later on. Then, in order to allocate the sales, in order to compute gross income from mining, which was by formula the sales times

the mining ratio, I used the figure—starting figure for the Stipulation of gross sales per the return. That figure is three million, seven hundred ninety-nine, three fifty-five point eighty-one. I added to that the bag costs, which Mr. Ashby just [53] testified, was not included in that figure. I also subtracted from that the purchase cement figure of thirty-seven thousand, nine hundred and thirty-seven point ninety-seven and the cash discounts of one sixty-four, six twenty-two point seventy-four—

Q Mr. Davitt, I'd prefer that you not read the numbers. I think it would be understood that the printed numbers on the exhibit would prevail over what the record might show.

A Okay. This arrived at a sales figure, which is identified there. That sales figure is then multiplied by the point two seven five ratio, to arrive at gross income for mining. That figure is then—from that figure I subtract the mining costs which are determined on the first page, to arrive at a taxable income figure—taxable income from the property. That figure is then divided in half or fifty per cent of it to establish the limitation. I multiplied fifteen per cent times the gross income from mining and determined that the allowable depletion is based upon the fifty per cent taxable income limitation and is the figure one hundred thirty-seven thousand, eight hundred and three dollars and sixty-four cents.

Q I have no further questions, Your Honor.

THE COURT: Any cross examination, Mr. Fuller?

[54] MR. FULLER: Yes.

CROSS EXAMINATION

BY MR. FULLER:

Q Mr. Davitt, except for a few dollars on one item there, the figures that you have used and Mr. Decker have used, do in fact conform, don't they?

A The figures that are involved here, yes.

Q Yes. The figures conform. The results are different.

A They are used a little differently.

Q And, have you had an opportunity to look at the deficiency notice, set in forth the deficiencies for the three years in the ninety day letter?

A Yes, I did see them.

Q And, would it be a fair statement to say that the original deficiency notice attempted to follow the Ideal Basic Decision? In a manner, at least.

A It attempted to—well, I'll have to be—this will have to be an opinion. In my opinion, it attempted to follow the Ideal to some extent, maybe not literally, but by interpreting the language of Ideal in connection with the case is cited in Ideal as a basis for their holding.

Q Now, would it be a fair statement to say that at this juncture of the case, you have abandoned any attempt to follow the Ideal Basic Decision? Literally.

[55] A Well, I'll put it this way. The computation that is performed here will produce the same result to my interpretation of Ideal.

Q And would it be a fair statement to say that your interpretation of Ideal would nullify any real meaning to that—of that decision?

A I don't know what you mean by a meaning to that decision.

Q Well, let's restate it. As you have attempted to follow Ideal Basic with the adjustments you have made to it, you would come around to a result, would you not, under the proportionate profits formula, that would render the Ideal Basic Decision a nullity or at least it would have no legal effect as being different from the law of other circuits?

A I'm afraid I can't answer that completely, because I didn't go back to re-examine all of the individual holdings in Ideal. I might summarize it by saying that if you interpret Ideal in a certain manner and not perhaps with the literal wording of Ideal decision, but by going back to other cases, you can get a result mathematically that will be similar to this result, except for perhaps for certain in-

direct allocations. But, the overall result will be esentially the same as this. And I'll put it this way. That in Ideal, they cited [56] considerably Standard Lime. Standard Lime talked about eliminations. They talked about these eliminations in connection with profits, so that where we make a one step adjustment here, in other words, we eliminate say, all of the non-mining all in one phase, the results that you could get from interpretations, I believe to be made under Ideal, by taking this in several steps. In other words, if you eliminated the bagging activity. But if you eliminate the cost of the bagging activity, both direct and indirect, and a profit to it and took that then out of the computation, and then took that point and started to work back, you would arrive at the same result that you can get this way.

Q And if that were the case and you did it that way then, we wouldn't worry about the Ideal Basic Decision, would we?

A Uh, well I don't know what you mean by "we worrying about the Ideal". I'm not.

Q Well, let's put it a little more bluntly. Isn't the purpose and the position of the respondent here in Court today one of attempting to get Ideal Basic Decision—the Ideal Basic Decision overruled.

A I think that's—

MR. FREED: Objection, Your Honor. He's not qualified to answer the question. I'll be glad to answer [57] it if the Court wants.

THE COURT: Well, if he can't answer it—I mean if he doesn't know, he can say I don't know, but—

MR. FREED: Well, he may know, but he is not qualified to answer.

THE COURT: I'm going to let him answer, Mr. Freed.

THE WITNESS: Would you state that question again so I can answer it?

MR. FULLER: Do you know whether it is a fact that the position of the respondent in this case is premised upon attempting to get the Ideal Basic Decision overruled?

A I believe the answer is yes, because the Ideal—

THE COURT: Well, you answered the question yes.

* * * * *

DEPLETION COMPUTATION
Fiscal Year Ending March 31, 1970
(Petitioner's Computation under U. S. v. Ideal Basic Industries, Inc., 404 F. 2d 122)

	Total	Mining	Non-Mining
Quarry	$221,604.56	$221,604.56	
Hauling	96,496.40	96,496.40	
Raw grinding & blending	383,872.61	304,526.14	$ 79,346.47
Purchased additives	129,358.72		129,358.72
Burning and cooling	917,352.00		917,352.00
Finish grinding	267,651.96		267,651.96
	$2,016,336.25	$622,627.10	$1,393,709.15

$622,627.10 ÷ $2,016,336.25 = 30.88 %

Allocate:

Indirect costs, less contributions (including P.C.A. dues)	348,466.44	107,606.44	240,860.00
Totals	$2,364,802.69	$730,233.54	$1,634,569.15

Gross Sales:	$3,799,355.81
Less : Cash discounts	- 164,622.74
Less: Sales of purchased cement	- 37,937.97
Net sales of manufactured cement	$3,596,795.10
Eliminate from the computation:	
Direct storing & shipping expenses	- 182,108.16
Direct selling expenses	- 47,178.47
	$3,367,508.47
Mining costs percentage computed above	30.88%
Gross income from mining	$1,039,886.62
Depletion rate.	15%
Depletion allowance	$ 155,982.99

LIMITATION

Gross income from mining	$1,039,886.62
Less: Total direct and indirect mining costs	- 730,233.54
Net income from mining	$ 309,653.08
	50%
Limitation:	$ 154,826.54

[Exhibit 7]

DEPLETION COMPUTATION

Fiscal Year Ending March 31, 1971

(Petitioner's Computation under U. S. v. Ideal Basic Industries, Inc., 404 F. 2d 122)

	Total	Mining	Non-Mining
Quarry	$225,752.56	$225,752.56	
Hauling	88,758.45	88,758.45	
Raw grinding & blending	388,817.42	280,959.47	$107,857.95
Purchased additives	134,904.91		134,904.91
Burning & cooling	852,549.97		852,549.97
Finish grinding	321,539.18		321,539.18
	$ 2,012,322.49	$ 595,470.48	$1,416,852.01

$ 595,472.48 ÷ 2,012,322.94 = 29.59%

Allocate:

Indirect costs, less contributions (including P.C.A. dues)	257,496.55	76,193.23	181,303.32
Totals	$2,269,819.04	$671,663.71	$1,598,155.33

Gross Sales:	$3,571,698.61
Less: Cash discounts	- 150,987.27
Less: Sales of purchased cement	- 46,113.57
Net sales of manufactured cement	$3,394,597.77
Eliminate from the computation:	
Direct storing & shipping expense	- 217,970.58
Direct selling expenses	- 47,345.19
	+ 3,129,282.00
Mining costs percentage computed above	29.59%
Gross income from mining	$ 925,954.54
Depletion rate	14 %
Depletion allowance	$ 129,633.64

LIMITATION

Gross income from mining	925,954.54
Less: Total direct and indirect mining costs	- 671,663.71
Net income from mining	$ 254,290.83
	50 %
Limitation	$ 127,145.42

DEPLETION COMPUTATION

Fiscal Year Ending March 31, 1972

(Petitioner's Computation under U. S. v. Ideal Basic Industries, Inc., 404 F. 2d 122)

	Total	Mining	Non-Mining
Quarry	$267,040.52	$267,040.52	
Hauling	120,195.90	120,195.90	
Raw grinding & blending	402,582.94	328,346.65	$74,236.29
Purchased additives	112,007.80		112,007.80
Burning & Cooling	1,125,823.86		1,125,823.86
Finish grinding	324,823.65		324,823.65
	$2,352,476.67	$715,583.07	$1,636,893.60

$ 715,583 ÷ $2,352,477 = 30.42%

Allocate:			
Indirect costs, less contributions (including P.C.A. dues)	437,242.15	133,009.06	304,233.09
Totals	$2,789,718.82	$848,592.13	$1,941,126.69

Gross Sales:	$4,891,897.56
Less: Cash discounts	- 191,778.89
Less: Sales of purchased cement	- 44,687.34
Net sales of manufactured cement	$4,655,431.33
Eliminate from the computation:	
Direct storing and shipping expenses	- 228,744.12
Direct selling expenses	- 54,002.63
	$4,372,683.58
Mining costs percentage computed above	30.42%
Gross income from mining	$1,330,170.35
Depletion rate	14 %
Depletion allowance	$ 186,223.85

LIMITATION

Gross income from mining	$1,330,170.35
Less: Total direct and indirect mining costs	- 848,592.13
Net income from mining	$ 481,578.22
	50 %
Limitation	$ 240,789.11

EXF

PORTLAND CEMENT CO. OF UTAH
FYE 3-31-70
DEPLETION COMPUTATION

COST CLASSIFICATION	TOTAL	MINING	NONMINING	ALLOCABLE
Quarry	$ 221,604.56	$ 221,604.56		
Hauling Rock	$ 96,496.40	$ 96,496.40		
1) Raw Grind-Blending	$ 304,541.49	$ 304,541.49		
2) Raw Grind-Blending Purchased Additives	$ 79,331.12		$ 79,331.12	
Purchased Additives	$ 129,358.72		$ 129,358.72	
Burning-Cooling	$ 917,352.00		$ 917,352.00	
3) Finish Grinding	$ 267,651.96		$ 267,651.96	
Storing-Shipping-Bagging	$ 182,108.16		$ 182,108.16	
Bag Costs	$ 18,034.00		$ 18,034.00	
Selling Expense	$ 47,178.47		$ 47,178.47	
Total Direct Cost	$2,263,656.88	$ 622,642.45	$1,641,014.43	
Direct Cost Ratio		.2750		
PCA Dues	$ 35,268.85			$ 35,268.85
Indirect Costs	$ 314,255.59			$ 314,255.59
Contributions	$ (1,058.00)			$ (1,058.00)
Subtotal Allocable Costs	$ 348,466.44	$ 95,828.27	$ 252,638.17	$ (348,466.44)
Total Direct and Allocable Costs	$2,612,123.32	$ 718,470.72	$1,893,652.60	

[-1-]

[Exhibit F]

EXF

Mining Ratio = Total Mining Cost ÷ Total Cost

Mining Ratio = $718,470.72 ÷ $2,612,123.32 = .2750

Gross Income from Mining = Sales x Mining Cost Ratio

Sales = Gross Sales Per Return + Bag Costs - Purchased Cement - Cash Discounts

Sales = $3,799,355.81 +$18,034.00 -$37,937.97 -$164,622.74 = $3,614,829.10

Gross Income from Mining (GIFM) = $3,614,829.10 x .2750 =	$994,078.00
Less: Mining Costs	$718,470.72
Taxable Income from Property	$275,607.28
50% of Taxable Income	$137,803.64
15 % of GIFM	$149,111.70
Allowable Depletion	$137,803.64

96

FOOTNOTES:

(1) Adjust raw grinding and blending costs to compute cost of raw grinding and blending taxpayer's quarry rock on tonnage basis.

$$\frac{\text{tons quarry rock}}{\text{tons total material used}} = \frac{196,903}{196,903 + 34,997 + 2,728 + 13,567} = 79.334$$

$383,872.61 x 79.334 % = $304,541.49

(2) Cost of raw grinding and blending purchased additives.

$383,872.61 x 20.666 % = $79,331.12

(3) Includes cost of purchased gypsum.

PORTLAND CEMENT CO. OF UTAH
FYE 3-31-71
DEPLETION COMPUTATION

COST CLASSIFICATION	TOTAL	MINING	NONMINING	ALLOCABLE
Quarry	$ 225,752.56	$ 225,752.56		
Hauling Rock	$ 88,758.45	$ 88,758.45		
1) Raw Grind-Blending	$ 280,959.47	$ 280,959.47		
2) Raw Grind-Blending Purchased Additives	$ 107,857.95		$ 107,857.95	
Purchased Additives	$ 134,904.91		$ 134,904.91	
Burning-Cooling	$ 852,549.97		$ 852,549.97	
3) Finish Grinding	$ 321,539.18		$ 321,539.18	
Storing-Shipping-Bagging	$ 217,970.58		$ 217,970.58	
Bag Costs	$ 18,413.00		$ 18,413.00	
Selling Expense	$ 47,345.19		$ 47,345.19	
Total Direct Cost	$2,296,051.26	$ 595,470.48	$1,700,580.78	
Direct Cost Ratio		.2593		
PCA Dues	$ 20,032.84			$ 20,032.84
Indirect Costs	$ 238,088.71			$ 238,088.71
Contributions	$ (625.00)			$ (625.00)
Subtotal Allocable Costs	$ 257,496.55	$ 66,768.86	$ 190,727.69	$ (257,496.55)
Total Direct and Allocable Costs	$2,553,547.81	$ 662,239.34	$1,891,308.47	

Mining Ratio = Total Mining Cost ÷ Total Cost

Mining Ratio = $662,239.34 ÷ $2,553,547.81 = .2593

Gross Income from Mining = Sales x Mining Cost Ratio

Sales = Gross Sales Per Return + Bag Costs - Purchased Cement - Cash Discounts

Sales = $3,591,698.61 + $18,413.00 - $46,113.57 - $150,987.27 = $3,413,010.77

Gross Income from Mining (GIFM) = $3,413,010.77 x .2593 =	$884,993.69
Less: Mining Costs	$662,239.34
Taxable Income from Property	$222,754.35
50% of Taxable Income	$111,377.18
14 % of GIFM	$123,899.12
Allowable Depletion	$111,377.18

FOOTNOTES:

(1) Adjust raw grinding and blending costs to compute cost of raw grinding and blending taxpayer's quarry rock on tonnage basis.

$$\frac{\text{tons quarry rock}}{\text{tons total material used}} = \frac{161,379}{161,379 + 45,391 + 1,820 + 14,740} = 72.26$$

$388,817.42 x 72.26 % = $280,959.47

(2) Cost of raw grinding and blending purchased additives.

$388,817.42 x 27.74 % = $107,857.95

(3) Includes cost of purchased gypsum.

Attachment

PORTLAND CEMENT CO. OF UTAH
FYE 3-31-72
DEPLETION COMPUTATION

COST CLASSIFICATION	TOTAL	MINING	NONMINING	ALLOCABLE
Quarry	$ 267,040.52	$ 267,040.52		
Hauling Rock	$ 120,195.90	$ 120,195.90		
1) Raw Grind-Blending	$ 328,306.39	$ 328,306.39		
2) Raw Grind-Blending Purchased Additives	$ 74,276.55		$ 74,276.55	
Purchased Additives	$ 112,009.80		$ 112,009.80	
Burning-Cooling	$1,125,823.86		$1,125,823.86	
3) Finish Grinding	$ 324,823.65		$ 324,823.65	
Storing-Shipping-Bagging	$ 228,744.12		$ 228,744.12	
Bag Costs	$ 20,027.00		$ 20,027.00	
Selling Expense	$ 54,003.63		$ 54,003.63	
Total Direct Cost	$2,655,251.42	$ 715,542.81	$1,939,708.61	
Direct Cost Ratio		.2695		
PCA Dues	$ 18,186.85			$ 18,186.85
Indirect Costs	$ 420,735.30			$ 420,735.30
Contributions	$ (1,680.00)			$ (1,680.00)
Subtotal Allocable Costs	$ 437,242.15	$ 117,836.76	$ 319,405.39	$ (437,242.15)
Total Direct and Allocable Costs	$3,092,493.57	$ 833,379.57	$2,259,114.00	

Mining Ratio = Total Mining Cost ÷ Total Cost

Mining Ratio = $833,379.57 ÷ $3,092,493.57 = .2695

Gross Income from Mining = Sales x Mining Cost Ratio

Sales = Gross Sales Per Return + Bag Costs - Purchased Cement - Cash Discounts

Sales = $4,891,897.56 + $20,027.00 - $44,687.34 - $191,778.89 = $4,675,458.33

Gross Income from Mining (GIFM) = $4,675,458.33 x .2695 =	$1,260,036.02
Less: Mining Costs	$ 833,379.57
Taxable Income from Property	$ 426,656.45
50% of Taxable Income	$ 213,328.23
14 % of GIFM	$ 176,405.04
Allowable Depletion	$ 176,405.04

FOOTNOTES:

(1) Adjust raw grinding and blending costs to compute cost of raw grinding and blending taxpayer's quarry rock on tonnage basis.

$$\frac{\text{tons quarry rock}}{\text{tons total material used}} = \frac{237,211}{237,211 + 35,789 + 2,498 + 15,347} = 81.55$$

$402,582.94 x 81.55 % = $328,306.39

(2) Cost of raw grinding and blending purchased additives.

$402,582.94 x 18.45 % = $ 74,276.55

(3) Includes cost of purchased gypsum.

UNITED STATES TAX COURT

Docket No. 6306-73

[Filed September 16, 1977]

PORTLAND CEMENT COMPANY OF UTAH, A Corporation, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

JOINT MOTION TO REOPEN RECORD

THE PARTIES JOINTLY MOVE the Court to reopen the record in this case to receive as evidence the attached stipulations of fact.

IN SUPPORT THEREOF, the parties jointly state:

1. On May 9, 1977, the Court filed its memorandum opinion in this case, the opinion being designated T. C. Memo. 1977-137.

2. On June 8, 1977, respondent filed his "Motion for Reconsideration of Findings and Opinion," asking, *inter alia*, that the Court make findings relative to "bag premium."

3. By its Order dated June 9, 1977, and in a subsequent telephone conversation among the parties and the Court, the parties were requested to supplement the record with evidence concerning "bag premium."

4. Attached are stipulations by the parties concerning "bag premiums."

U.S. TAX COURT
GRANTED

SEP 23 1977
(signed) WM. M. FAY
JUDGE

WHEREFORE, the parties pray that the Court reopen the record in this case to receive the attached stipulation.

STUART E. SEIGEL
Chief Counsel
Internal Revenue Service

By: _____
S. CLAY FREED
Assistant Regional Counsel
P. O. Box 2520
Salt Lake City, Utah 84110
Tel. No. 801-524-5815
Date: Sep 12 1977

/s/ _____
GLEN E. FULLER
Counsel for Petitioner
15 East Fourth South
Salt Lake City, Utah 84111
Tel. No. 801-363-7187
Date: Sep 12 1977

UNITED STATES TAX COURT

Docket No. 6306-73

[Filed September 23, 1977]

PORTLAND CEMENT COMPANY OF UTAH, A CORPORATION, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

SUPPLEMENTAL STIPULATION OF FACTS

The parties agree that the following statements and attached exhibits may be accepted as facts for the purpose of this case.

1. Attached as Exhibit 8 is a copy of a document captioned "Calculation of Bag Premiums."

2. Attached as Exhibit 9 is a copy of a document captioned "Comparison of Bagging Costs with Bag Premium."

3. Attached as Exhibit 10 are copies of documents showing for each of the fiscal years ended March 31, 1970, 1971, and 1972, the method used in determining bagging costs shown on Exhibit 9.

4. The parties agree that although for each year there was an excess of costs over bag premium, as shown on

Exhibit 9, petitioner nevertheless realized a net profit on the sale of each bag of cement.

STUART E. SEIGEL
Chief Counsel
Internal Revenue Service

By: _____
S. CLAY FREED
Assistant Regional Counsel
P. O. Box 2520
Salt Lake City, Utah 84110
Tel. No. 801-524-5815

Date: Sept 12, 1977

GLEN E. FULLER
Counsel for Petitioner
15 East Fourth South
Salt Lake City, Utah 84111
Tel. No. 801-363-7187

Date: Sept. 12, 1977

PORTLAND CEMENT COMPANY OF UTAH

CALCULATION OF BAG PREMIUMS

	Bulk	Bags	Premium for Bagged Cement	Bag Premium
4/1/69 to 12/31/69	$4.33/bbl.	5.13/bbl.	.80/bbl.	
Barrels of bagged cement sold			52,333-1/2	41,866.80
1/1/70 to 3/31/70	4.58/bbl.	5.48/bbl.	.90/bbl.	
Barrels of bagged cement sold			8,078	7,270.20
				49,137.00
4/1/70 to 12/31/70	4.58/bbl.	5.48/bbl.	.90/bbl.	
Barrels of bagged cement sold			52,491-1/2	47,242.35
1/1/71 to 3/31/71	4.83/bbl.	5.83/ bbl.	1.00/bbl.	
Barrels of bagged cement sold			8,935-1/4	8,935.25
				56,177.60
4/1/71 to 12/31/71	4.83/bbl	5.83/bbl.	1.00/bbl.	
Barrels of bagged cement sold			50,521-1/2	50,521.50
1/1/72 to 3/31/72	1/28 cwt. 4.8128/bbl	1.46/bag 5.84/bbl.		
Barrels of Bagged Cement sold			14,316-1/4	
		DKT NO. 6366-73		14,705.65
		P EXH. 8		65,227.15

[Exhibit 8]

PORTLAND CEMENT COMPANY OF UTAH

COMPARISON OF BAGGING COSTS WITH BAG PREMIUM

	FY 3/31/70	FY 3/31/71	FY 3/31/72
Bag premium	$ 49,137.00	$ 56,177.60	$ 65,227.15
Cost of empty bags	18,034.00	18,413.00	20,027.00
Bagging Costs:			
Payroll and benefits	51,981.63	58,988.58	63,386.53
Supplies and maintenance	1,965.26	3,784.41	4,000.73
Electrical	3,038.76	2,809.64	3,435.12
Shop	6,194.78	13,260.39	10,985.96
General costs applied	17,564.87	19,512.46	20,795.80
Power	5,699.05	5,356.40	6,365.97
Depreciation	69.53	720.17	820.45
	104,547.88	122,845.05	129,817.56
Excess of costs over bag premium	$ 55,410.88	$ 66,667.45	$ 64,590.41

DKT NO. 6306-73
P EXH. 9

[Exhibit 9]

PORTLAND CEMENT COMPANY OF UTAH

ALLOCATION OF STORING, SHIPPING & BAGGING EXPENSES

FISCAL YEAR ENDED MARCH 31, 1970

		Bulk	Bags	
	Foreman	Bulk-Loaders	Wheelers & Bagging Mach. Op.	Total
3/31/70 Labor	9,550.00	15,502.38	37,182.91	62,235.29
	15.4%	24.9%	59.7%	100 %
Profit Sharing	1,179.90			1,179.90
Employee Benefits	1,576.26	2,548.63	6,110.57	10,235.46
	12,306.16	18,051.01	43,293.48	73,650.65
		29.4 %	70.6%	
Allocate Foreman	(12,306.16)	3,618.01	8,688.15	
Labor, Employee benefits and Profit Sharing		21,669.02	51,981.63	73,650.65
Supplies and maintenance	(50-50)	1,965.26	1,965.26	3,930.52
Electrical	(50-50)	3,038.76	3,038.76	6,077.52
Shop	(50-50)	6,194.78	6,194.78	12,389.56
General Mfg. Costs.	(50-50)	17,564.88	17,564.87	35,129.75
Power	(25-75)	1,899.68	5,699.05	7,598.73
Switching charges		3,922.13	-0-	3,922.13
Rental- Storage silos		30,000.00	-0-	30,000.00
Depreciation		9,339.77	69.53	9,409.30
		95,594.28	86,513.88	182,108.16

DKT NO. 6306-73
P EXH. 10

[Exhibit 10]

PORTLAND CEMENT COMPANY OF UTAH

ALLOCATION OF STORING, SHIPPING & BAGGING EXPENSES

FISCAL YEAR ENDED MARCH 31, 1971

		Bulk	Bags	
	Foreman	Bulk Loaders-	Wheelers and Baggers	Total
Labor	10,350.00	18,622.42	42,108.09	71,080.51
Comparative percentage	14.6%	26.2 %	59.2 %	100%
Profit -Sharing	1,073.10	-0-	-0-	1,073.10
Employee Benefits	1,888.10	3,388.22	7,655.83	12,932.15
	13,311.20	22,010.64	49,763.92	85,086.76
		30.7%	69.3 %	
Allocate foreman	(13,311.20)	4,086.54	9,224.66	
Labor, employee benefits and Profit Sharing		26,097.18	58,988.58	85,085.76
Supplies and maintenance		3,784.41	3,784.41	7,568.82
Electrical		2,809.65	2,809.64	5,619.29
Shop		13,260.39	13,260.39	26,520.78
General Manufacturing Costs		19,512.46	19,512.46	39,024.92
Power		1,785.47	5,356.40	7,141.87
Switching Charges		4,049.22	-0-	4,049.22
Rental of storage silos		30,000.00	-0-	30,000.00
Depreciation		12,239.75	720.17	12,959.92
		113,538.53	104,432.05	217,970.58

PORTLAND CEMENT COMPANY OF UTAH

ALLOCATION OF STORING, SHIPPING & BAGGING EXPENSES

FISCAL YEAR ENDED MARCH 31, 1972

		Bulk	Bags	
	Foreman	Bulk Loaders (Toppers)	Wheelers and Baggers	Total
Labor	10,550.00	22,610.64	44,951.62	78,112.26
comparate percentage	13.5%	28.9%	57.6 %	100%
Profit Sharing	1,579.20			1,579.20
Employee Benefits	2,102.53	4,500.98	8,970.81	15,574.32
	14,231.73	27,111.62	53,922.43	95,265.78
		33.5 %	66.5%	
Allocate foreman	(14,231.73)	4,767.63	9,464.10	
Labor, employee benefits and Profit Sharing		31,879.25	63,386.53	95,265.78
Supplies and maintenance		4,000.72	4,000.73	8,001.45
Electrical		3,435.13	3,435.12	6,870.25
Shop		10,985.95	10,985.96	21,971.91
General Manufacturing Costs		20,795.80	20,795.80	41,591.60
Power (25-75)		2,121.99	6,365.97	8,487.96
Switching Charges		3,417.49		3,417.49
Rental of storage silos		30,000.00		30,000.00
Depreciation		12,317.23	820.45	13,137.68
		118,953.56	109,790.56	228,744.12

UNITED STATES TAX COURT

Docket No. 6306-73

[Filed November 11, 1977]

PORTLAND CEMENT COMPANY OF UTAH, A CORPORATION, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

RESPONDENT'S COMPUTATION FOR ENTRY OF DECISION

The attached computation is submitted, on behalf of the respondent, in compliance with the Court's opinion determining the issues in this case, together with a proposed decision which is being lodged concurrently with said computation.

This computation is being submitted without prejudice to respondent's right to contest the correctness of the decision entered herein by the Court.

STUART E. SEIGEL,
Chief Counsel,
Internal Revenue Service.

By: _____

S. CLAY FREED
Assistant Regional Counsel

OF COUNSEL:
EMORY L. LANGDON,
Regional Counsel,
S. CLAY FREED,
Attorney,
Internal Revenue Service.
P.O. Box 2520
Salt Lake City, Utah 84110
Tel. No. (801) 524-5815

Without prejudice to the right of appeal, it is agreed that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled case.

/s/ _____
GLEN E. FULLER,
Counsel for Petitioner.

CC: SLC: TC
SCF: JAG

COMPUTATION STATEMENT

In re: Portland Cement Company of Utah,
A Corporation
615 West 8th South Street
P.O. Box 1469
Salt Lake City, Utah 84110

Docket No. 6306-73

Income Tax

Year Ended	Deficiency
March 31, 1970	$ 34,303.60
March 31, 1971	33,409.08
March 31, 1972	564.63
Total	$ 68,277.31

Recomputation of tax liability has been prepared in accordance with the opinion of the United States Tax Court, filed May 9, 1977.

The details supporting the above computations are set forth on the attached pages 1 to 3 inclusive.

[Page 1]

Form 3613 (Rev. April 1974)	Department of the Treasury - Internal Revenue Service CORPORATION INCOME TAX	Statement Schedule 1

Name: Portland Cement Co. of Utah

	Tax Years Ended		
	3.31.70	3.31.71	3.31.72
Taxable Income as Shown in: ☐ Return as Filed ☐ Preliminary Letter Dated ☑ Statutory Notice Dated May 23, 1973	*950,532.00	*859,528.00	*1,513,661.00
Increases (or Decreases) in Income: (See attached explanation of items) From Sch. 2	⟨18,956.54⟩	⟨16,666.42⟩	⟨13,773.85⟩
Taxable Income as Revised	931,575.46	842,861.58	1,499,887.15
Tax Computation A. Less: Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss (Alternative tax computation)			
B. ~~Income Subject to Tax~~ Sch. 3 - Tax	442,156.21	398,122.65	713,877.07
C. ~~Partial Tax for Income on Line B~~ surcharge			
D. ~~Alternative Tax for Years Beginning Before 1-1-75 — Per SEC. 1201 IRC~~ ✓ .0876712	38,764.27		
E. ~~Alternative Tax for Years Beginning After 12-31-74 — 30% of Line A~~ ✓ .0124657		4,962.59	
F. Other Taxes Inv. Cr. Recap. per return	307.79		
G. SUBTOTAL (Lines C, D or E, and F)	481,228.27	403,085.24	713,877.07
H. Tax Credits Investment per return	4,547.03	530.91	5,043.76
I. Income Tax Liability (Line G less Line H)	476,681.24	402,554.33	708,833.31
J. Income Tax Liability Shown on Return and Previous Increase (or Decrease) in Tax Return as filed	442,377.64	369,145.25	708,268.68
K. Increase (or Decrease) in Tax	34,303.60	33,409.08	564.63

GPO 875-[illegible]

Form 3613 (Rev. 4-74)

[Page 21

FORM 4087 JUNE 1967	U. S. TREASURY DEPARTMENT - INTERNAL REVENUE SERVICE ADJUSTMENTS TO INCOME (Supplemental Schedule)	STATEMENT SCHEDULE 2

NAME

Portland Cement Co. of Utah

INCREASES (DECREASES) IN INCOME:	TAXABLE YEAR ENDED 3.31.70	3.31.71	3.31.72
	$	$	$
(a) Depletion Expense			
Per statutory notice	135,870.00	110,479.00	175,184.00
As determined by Court	154,826.54	127,145.42	186,223.85
⟨Decrease⟩ income	⟨18,956.54⟩	⟨16,666.42⟩	⟨11,039.85⟩
(b) Other Deductions -			
Customer Entertaining			
To reverse SN			⟨2,734.00⟩
NET INCREASE (DECREASE) IN INCOME TO STATEMENT SCHEDULE 1	$ ⟨18,956.54⟩	$ ⟨16,666.42⟩	$ ⟨13,773.85⟩

Page 3 of 3 pages

FORM 4549-D (DECEMBER 1970)

DEPARTMENT OF THE TREASURY - INTERNAL REVENUE SERVICE

INCOME TAX AUDIT CHANGES Schedule 3

COMPUTATION OF ALTERNATIVE TAX - CORPORATIONS

TAXPAYER'S NAME: Portland Cement Co. of Utah

EMPLOYER IDENTIFICATION NUMBER:

		Year: 3-31-70	Year: 3-31-71	Year: 3-31-72
PART I Complete for all years	1. CORRECTED TAXABLE INCOME (From Sch. 1)	931,575.46	842,861.58	1,499,887.15
	2. NET LONG-TERM CAPITAL GAIN MINUS NET SHORT-TERM CAPITAL LOSS	-0-	7,437.50	5,937.50
	3. LINE 1 LESS LINE 2	931,575.46	835,424.08	1,493,949.65
	4. SURTAX EXEMPTION (Line 3, $25,000, or amount apportioned under section 1561, whichever is lesser)	25,000.00	25,000.00	25,000.00
	5. LINE 3 LESS LINE 4	906,575.46	810,424.08	1,468,949.65
	6. a. FOR YEARS ENDING BEFORE 1/1/70 - 25% OF LINE 2 b. FOR YEARS ENDING AFTER 12/31/69 - AMOUNTS FROM LINE 18	-0-	2,119.10	1,781.25
	7. 22 % (Year: 3-31-70) / 22 % (Year: 3-31-71) / 22 % (Year: 3-31-72) OF LINE 3	204,946.60	183,793.29	328,668.92
	8. 26 % (Year: 3-31-70) / 26 % (Year: 3-31-71) / 26 % (Year: 3-31-72) OF LINE 5	235,709.61	210,710.26	381,926.90
	9. IF MULTIPLE SURTAX EXEMPTION ELECTED UNDER SECTION 1562, ENTER 6% OF LINE 4	1,500.00	1,500.00	1,500.00
	10. ALTERNATIVE TAX (Add lines 6 through 9)	442,156.21	398,122.65	713,877.07
PART II Complete for all years ending after 12/31/69	11. NET LONG-TERM CAPITAL GAIN REDUCED BY ANY NET SHORT TERM CAPITAL LOSS	-0-	7,437.50	5,937.50
	12. LONG-TERM CAPITAL GAIN (section 1201 (d) IRC)*	-	-	-
	13. LINE 11 LESS LINE 12 (if less than zero, enter zero)	-0-	7,437.50	5,937.50
	14. 25% OF THE LESSER OF LINE 12 OR LINE 13	-0-	-0-	-0-
	15. a. FOR CALENDAR YEAR 1970 - 28% OF LINE 13 b. FOR CALENDAR YEARS 1971 THROUGH 1974 AND FISCAL YEARS ENDING IN 1972 THROUGH 1974 - 30% OF LINE 13 c. FOR FISCAL YEARS ENDING 1970 AND 1971 - AMOUNTS FROM LINES 19 & 22	-0-	2,119.10	1,781.25
	16. ADD LINES 14 AND 15 (enter on line 6, above)	-0-	2,119.10	1,781.25
PART III Complete only for fiscal year ending in 1970	17. AMOUNT ON LINE 13 x (NO. DAYS BEFORE 1/1/70 / 365) x 25%	-0-		
	18. AMOUNT ON LINE 13 x (NO. DAYS AFTER 12/31/69 / 365) x 28%	-0		
	19. ADD LINES 17 AND 18 (enter on line 15c, above)	-0-		
PART IV Complete only for a fiscal year ending in 1971	20. AMOUNT ON LINE 13 x (NO. DAYS BEFORE 1/1/71 / 365) x 28%		1,568.95	
	21. AMOUNT ON LINE 13 x (NO. DAYS AFTER 12/31/70 / 365) x 30%		550.15	
	22. ADD LINES 20 AND 21 (enter on line 15c, above)		2,119.10	

*Long term capital gains from certain binding contracts, distributions, and installment sales

FORM 4549-D (12-70)

STATEMENT OF ACCOUNT

SCHEDULE NUMBER 1

NAME Portland Cement Company of Utah

KIND OF TAX Income | DOCKET NUMBER 6306-73 | SYMBOLS AP: SLC: JAG

	TAXABLE YEAR ENDED					
	3.31.70		3.31.71		3.31.72	
	DATE	AMOUNT	DATE	AMOUNT	DATE	AMOUNT
REVISED LIABILITY		$476,681.24		$402,554.33		$708,833.31
ASSESSED (Disclosed by return)		442,377.64		369,145.25		708,268.68
ADDITIONAL ASSESSMENTS						
OVERASSESSMENTS						
TOTAL (Net) ASSESSMENTS		442,377.64		369,145.25		708,268.68
DEFICIENCY IN ASSESSMENT (Overassessment)		$ 34,303.60		$ 33,409.08		$ 564.63
REVISED LIABILITY		476,681.24		402,554.33		708,833.31
PAYMENTS	6.15.9	27,646.93	6.15.0	55,269.29	6.15.1	46,124.04
	7.16.9	40,000.00	7.14.0	90,000.00	7.13.1	100,000.00
	9.15.9	80,000.00	9.14.0	90,000.00	9.10.1	125,000.00
	12.15.9	175,000.00	12.15.0	90,000.00	12.14.1	200,000.00
	3.12.0	175,000.00	3.15.1	90,000.00	3.15.2	250,000.00
LESS REFUNDS OR CREDITS	6.15.0	55,269.29	6.15.1	46,124.04	6.16.2	12,855.36
TOTAL (Net) PAYMENTS		442,377.64		369,145.25		708,268.68
DEFICIENCY IN PAYMENT (Overpayment)		$ 34,303.60		$ 33,409.08		$ 564.63

TAXABLE YEAR ENDED	IR CODE REFERENCE SECTION	IR CODE REFERENCE YEAR	DATE RETURN FILED	DATE AGREEMENT EXECUTED	STATUTE EXTENDED TO	DATE DEFICIENCY NOTICE MAILED	DATE CLAIM FILED	AMOUNT OF CLAIM
		19__						
		19__						
		19__						

UNITED STATES TAX COURT

Docket No. 6306-73

PORTLAND CEMENT COMPANY OF UTAH, A CORPORATION, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

DECISION

Pursuant to the opinion of the Court filed May 9, 1977, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years ended March 31, 1970, March 31, 1971, and March 31, 1972, in the amounts of $34,303.60, $33,409.08, and $564.63, respectively.

/s/ _____
JUDGE.

ENTERED: Nov 22 1977

* * * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this

SERVED NOV 22, 1977

decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

STUART E. SEIGEL,
Chief Counsel,
Internal Revenue Service.

BY: /s/ _____
S. CLAY FREED
Assistant Regional Counsel
P.O. Box 2520
Salt Lake City, Utah 84110
Tel. No. (801) 524-5815
Date: November 7, 1977

/s/ _____
GLEN E. FULLER
Counsel for Petitioner
15 East Fourth South
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Tel. No. (801) 363-7187
Date: Nov. 14, 1977

Supreme Court of the United States

No. 79-1907

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

PORTLAND CEMENT COMPANY OF UTAH

ORDER ALLOWING CERTIORARI. Filed October 6, 1980

The petition herein for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit is granted.

☆U.S. GOVERNMENT PRINTING OFFICE: 1980 331952 116

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No. 79-1907

In the Supreme Court of the United States

OCTOBER TERM, 1979

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PORTLAND CEMENT COMPANY OF UTAH,
Respondent

On Petition for a Writ of Certiorari to the
United States Court of Appeals
for the Tenth Circuit

BRIEF FOR PORTLAND CEMENT COMPANY OF UTAH IN OPPOSITION

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In the Supreme Court of the United States

No. 79-1907

OCTOBER TERM, 1979

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PORTLAND CEMENT COMPANY OF UTAH,
Respondent

On Petition for a Writ of Certiorari to the
United States Court of Appeals
for the Tenth Circuit

BRIEF FOR PORTLAND CEMENT COMPANY OF UTAH IN OPPOSITION

The questions presented by petitioner are concerned with details of the application for income tax depletion purposes of the so-called "proportionate profits" method of determining gross income from mining to respondent, an integrated miner-manufacturer of cement. Respondent opposes the issuance of a writ of certiorari for the reasons hereinafter set forth.

ARGUMENT

I.

THE QUESTIONS PRESENTED BY PETITIONER CONSTITUTE A SUBSTANTIAL DEPARTURE FROM THE PRIMARY ISSUE WHICH WAS DECIDED IN THE COURTS BELOW; AND, ON THE ISSUES ACTUALLY PRESENTED, THE COURTS BELOW CORRECTLY APPLIED BOTH DECISIONAL LAW AND APPLICABLE TREASURY REGULATIONS

The petitioner in this matter expresses disapproval with the case of *United States v. Ideal Basic Industries, Inc.*, 404 F.2d 122, cert. denied, 395 U.S. 936, rehearing denied, 396 U.S. 975, wherein it was held by the Tenth Circuit that for income tax depletion purposes of cement producers the "first marketable product" under Treasury Regulations is bulk cement. As such, a frontal attack is being attempted by petitioner for a second time in an attempt to have this Court issue a writ of certiorari some eleven years later, claiming that "developments" have occurred in the interim period.

It is interesting to note, however, that the matter was pursued by petitioner in both lower courts on the basic premise that certain changes in the Treasury Regulations in 1972 had brought about a change in the definition of "first marketable product", thereby circumventing the ruling of *Ideal Basic* by the oblique approach of leaving that decision suspended without any

underlying support. In substance, petitioner took the position that the power granted by Congress to issue Regulations was controlling on the Courts, and that, in fact, Treasury Regulations were changed so as to circumvent *Ideal Basic*.

The changed Regulations considered by the Tenth Circuit and the Tax Court below were also brought to the attention of this Court in *Ideal Basic* when certiorari was sought in 1969, wherein it was belatedly argued that the new Regulations should justify a change in the *Ideal Basic* decision; further, it was also brought out at that time that there was a conflict in certain particulars of the Tenth Circuit decision in *Ideal Basic* with those of cases in both the Fourth Circuit and the Ninth Circuit. There has been no significant change since then.

Both the Tax Court and the Tenth Circuit were primarily concerned with whether Treasury Regulations had in fact altered the definition of "first marketable product", and both courts held that no such change had been made. The Tenth Circuit observed in its recent opinion found in 614 F. 2d 724, as follows:

> "The Tax Court held that the changes in the Treasury Regulations in 1972 (Sec. 1.613-4 (d) (4)) would not bring about a change in the result reached in *Ideal Basic*. It determined that the basic consideration was that of the 'first marketable product.' It noted that the 1972 Regulations carried over the same provisions as were relied on in *Ideal Basic Industries* in the 1968 Regulations. We can add little if anything to

> the analysis made by the Tax Court, and we agree with the conclusion reached."

As pointed out in the Tax Court opinion at 36 T.C.M. 578, petitioner there argued that the rule of *Golsen v. Commissioner*, 57 T. C. 742, aff'd 445 F. 2d 985, cert. denied, 404 U. S. 940, would not bind the Tax Court to the decision in *Ideal Basic* inasmuch as pertinent Regulations adopted subsequent to the Tenth Circuit's decision in *Ideal Basic* had worked a change in the legal atmosphere so as to make the *Golsen* rule inapplicable.

In holding that the new Regulations had not accomplished the result claimed by the Commissioner, the Tax Court refused to accept the government's position and concluded that *Golsen* should apply:

> "Respondent's view, however, overlooks a pivotal consideration. Nothwithstanding the new regulation's specific mention of bags and bagging costs, such additional language does not purport to alter the definition of the makeup of the elements which constitute the first marketable product.[6] Rather, such change merely clarifies the classification among certain costs which are common to almost all integrated mining-manufacturing operations."[7]

---

[6] Sec. 1.613-4 (d) 4 (iv), which defines the term "first marketable product," was transferred completely intact from the old to the new regulatory material.

[7] Indeed, the Tenth Circuit takes no issue with the view that the cost of bags and bagging constitutes non-mining expenses. See **Ideal Basic Industries**, supra, at 125.

The Tenth Circuit seems to have little quarrel that costs of bags and bagging cement, bulk loading, ad-

vertising and selling are non-mining costs under the so-called "proportionate profits" formula utilized in the cement and other extractive mineral industries, but it does take a definite position that bulk cement, rather than both bulk and bagged cement, constitutes the "first marketable product" under the Regulations and that non-mining costs beyond the bulk cement stage should be excluded entirely from the "proportionate profits" formula. If, as petitioner before this Court has contended in the courts below, it can define "first marketable product" by Regulations which are binding on all courts, then it would seem that petitioner should proceed to adopt new Regulations accomplishing its desired purpose rather than petition this Court to overrule existing case law or, indeed, its own Regulations.

II.

THE POINT AT WHICH CEMENT BECOMES THE "FIRST MARKETABLE PRODUCT" UNDER TREASURY REGULATIONS INVOLVES ONLY ONE RELATIVELY MINOR ISSUE AMONG MANY PROBLEMS CREATED BY THE "PROPORTIONATE PROFITS" METHOD OF ARRIVING AT CONSTRUCTIVE INCOME FROM MINING.

Inherent in any discussion of income tax depletion allowances in the cement industry, and many other extractive industries, is a consideration of the "proportionate profits" formula for determining a constructive gross sales figure at the point where mining terminates in

those instances where actual sales of the product do not occur because of an integrated manufacturing process. In the case of cement, Section 613 (c) (4) (F) of the Code provides that mining ceases at the point where the raw mineral product is finely ground, mixed with water to form a slurry, and fed into rotating kilns for burning. All mining costs prior to the kiln-feed point are totaled and the percentage that those costs bear to the total cost of producing the "first marketable product" forms the basis from which can be determined the gross income from mining.

Petitioner asserts (Br. 13) that the basic theory of the "proportionate profits" methods is that ". . . every dollar of the producer's costs, mining and non-mining alike, is deemed to produce the same proportionate part of the profits earned through sales of the first marketable product; . . ." Further, it is contended by petitioner that the premise that every dollar of costs produces the same rateable part of the profits is in accord with long-settled principles of corporate accounting.

It is certainly true, as accountants universally recognize, that every dollar of costs must be taken into account in arriving at profits, but to suggest that every dollar of costs produces the same proportionate part of the profits is the most inaccurate and absurd statement imaginable, more likely to be accepted by participants in bankruptcy court than in the arena of competitive business activities. It requires little imagination to perceive that profits are the result of an excess of receipts over costs, and that any business which can reduce its

costs in relation to its receipts will show the greater relative percentage of profits.

The "proportionate profits" formula is a misnomer; it is a proportionate *costs* formula — and nothing more. It does not realistically provide a depletion allowance commensurate with a return of the miner's capital interest in depletable materials.

Thus, in applying the "proportionate profits" formula, a cement producer having a deposit of raw materials which is of relatively poor quality, or which is very difficult to quarry, or who exercises poor management or allows its machinery to be poorly maintained or damaged, would likely find that the proportion of the costs expended in the production of its first marketable cement product would lean very heavily to the "mining" side of the "proportionate profits" formula. On the other hand, a cement producer operating efficiently and with a choice deposit of raw materials would find that the percentage attributable to its "mining" operations would usually be smaller than that of its less efficient competitor with a poorer deposit. As such, the application of the "proportionate profits" formula actually operates as a subsidy to the inefficient, high cost producer by furnishing it with a higher "mining" percentage — and a greater amount of depletion, and places the efficient producer with a quality deposit at a competitive disadvantage.

The foregoing brief illustration of how the "proportionate profits" formula operates has been advanced at this point primarily to bring into proper focus peti-

tioner's representation (Br. 10) that there are "currently 24 proportionate profits cases presently pending either in the courts or administratively with approximately $26 million at stake."

Because of the inherent fallacy of the "proportionate profits" formula, it is entirely possible that the representation is accurate if we consider pending cases involving *all aspects* of the "proportionate profits" formula. But respondent challenges the implication and submits that the nature of the narrow issue here presented involves only a small fraction of the quoted amount, and further suggests that petitioner's representation is a calculated misrepresentation.

The number of cases presently pending involving the determination of "first marketable product" in the cement industry, and the application of non-mining costs beyond that point in applying the formula, should certainly be relatively few in number and a small portion of the total monetary amount at issue since the various aspects of the "proportionate profits" formula which can give rise to litigation are undoubtedly very numerous. Although respondent does not have access to the information, petitioner's generalized statement of pending "proportionate profits cases" is of no help in assessing the monetary impact of the narrow "first marketable product" issue in the cement industry.

To illustrate the relative small difference in the corporate income taxes payable by utilizing the "first marketable product" concept of *Ideal Basic* and com-

paring the corporate income taxes payable on the same group of costs by applying petitioner's version of the "proportionate profits" formula, we find a good illustration in this particular case. Subject to possible incidental adjustments, a computation of respondent's corporate income tax reduction under *Ideal Basic* would result in a lowered tax liability for the three fiscal years involved, in the following amounts:

Fiscal year ended March 31, 1970	$10,045.98
Fiscal year ended March 31, 1971	$ 8,138.91
Fiscal year ended March 31, 1972	$ 5,299.29
Total	$23,484.18[1]

When one considers that respondent paid federal corporate income taxes for the three fiscal years from its cement-producing operations in an amount exceeding $1,500,000, the relative importance of the narrow and technical issue raised by petitioner dwarfs what appears to be a vendetta against respondent by petitioner. It should be noted that these litigants have been before the Tenth Circuit on six different occasions involving the proper method of computing respondent's depletion allowance. On the fifth appeal, in *Portland Cement Co. of Utah v. United States* (1969), 412 F.2d 894, the case was remanded to have respondent's depletion allowance computed under *Ideal Basic* — and petitioner did not seek certiorari. Having failed in its attempt to

[1] The greater amount of deficiency shown in the Tax Court decision (Petitioner's Brief 1a) was mostly due to the fact that in the first two years respondent computed its depletion allowance on a method other than the "proportionate profits" formula.

convince the Tax Court and the Tenth Circuit that its Treasury Regulations did in fact over-ride *Ideal Basic* and the fifth *Portland Cement Co. of Utah* decision, petitioner is now falling back on the approach it should have undertaken against respondent back in 1969.

A review of some of the cases cited by petitioner involving the "proportionate profits" formula reveals the existence of several issues in nearly every case. As an example, in *General Portland Cement Co. v. United States*, 438 F. Supp. 27 (appeal pending to the Fifth Circuit) the issue of first marketable product of that cement producer was resolved to include both bagged and bulk cement where the facts established that up to 20%[2] of its cement sales were made in bags; but on a separate issue—one of several, the court held that cash discounts should not be deducted from gross sales.

Petitioner's other cases which deal with cash discounts in the cement industry are *Southwestern Portland Cement Co. v. United States*, 435 F. 2d 504, and *United States v. California Portland Cement Co.*, 413 F. 2d 161—both of which held such discounts to be "trade" discounts, and deductible from gross sales.

To compound the areas of confusion under the "proportionate profits" formula, the handling of selling and marketing expenses has given the courts no end of trouble. In *Arvonia-Buckingham Slate Co. v. United*

---

[2] Respondents bagged cement sales, by contrast, were testified at the trial to be:

Fiscal year ended 3/31/70	7.0%
Fiscal year ended 3/31/71	8.0%
Fiscal year ended 3/31/72	6.5%

States, 426 F. 2d, 484, *California Portland* and *Southwestern Portland*, the courts held that selling expenses should be allocated between mining and non-mining costs in the formula. On the other hand, a contrary result was reached in *Mississippi Valley Portland Cement Co. v. United States*, 347 F. Supp. 240. The courts have recognized the inherent difficulties in allocating selling and marketing costs between mining and non-mining segments of the formula.

Petitioner should really have little concern with the relatively insignificant issue of when a cement producer creates its "first marketable product" under the "proportionate profits" formula; rather, petitioner should be more concerned with arriving at a better degree of justice among miners by submitting to this Court the issue of the validity of the "proportionate profits" formula itself. In 1967, after the Tenth Circuit decided that this respondent should compute its depletion allowance under the "proportionate profits" formula in *United States v. Portland Cement Co. of Utah*, 378 F. 2d 91, this respondent attempted to secure a writ of certiorari from this Court (October Term, 1967 — No. 640). In so doing, respondent there sought to test the validity of the "proportionate profits" formula. However, certiorari was denied, 389 U. S. 975.

Since the "proportionate profits" formula is arbitrary and reaches a result which often goes in a direction clearly opposite to the intent of the law in providing a depletion allowance for the exhaustion of the value of the mineral deposit, it is understandable that

petitioner will be subjected to litigation from many different sources involving its application.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Supreme Court, U. S.
FILED
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MICHAEL RODAK, JR., CLERK

No. 79-1907

In the Supreme Court of the United States

OCTOBER TERM, 1980

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PORTLAND CEMENT COMPANY OF UTAH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1980

No. 79-1907

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PORTLAND CEMENT COMPANY OF UTAH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

QUESTIONS PRESENTED

Where the depletable "gross income from mining" under Section 613(c)(1) of the Internal Revenue Code of 1954 of an integrated miner-manufacturer of cement must be determined under the "proportionate profits" method, *i.e.*, an allocation of the receipts from the sale of its first marketable manufactured product to the mining phase of its operation in the ratio that its mining costs bear to its total (mining plus nonmining) costs:

1. Whether, in determining the amount of income to be allocated in accordance with the costs ratio, the income is to be computed on the assumption that only cement sold in bulk is respondent's first marketable product, as the decision below held, or that cement sold in bulk and in bags constitutes respondent's first marketable product, in accordance with the governing Treasury Regulations.

2. Whether, in determining the ratio of mining to total costs, post-manufacturing costs of bags, bagging, storage, distribution, and sales should be included in the proportionate profits computation as nonmining costs, in accordance with the governing Treasury Regulations.

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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Pet. App. 1a-11a) are unofficially reported at 36 T.C.M. 578. The opinion of the court of appeals (Pet. App. 12a-16a) is reported at 614 F.2d 724.

JURISDICTION

The judgment of the court of appeals was entered on February 5, 1980 (Pet. App. 17a). By order dated April 24, 1980, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 4, 1980. The petition was filed on June 3, 1980, and was granted on October 6, 1980 (J.A. 118). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of Sections 611 and 613 of the Internal Revenue Code of 1954 (26 U.S.C.), Treasury Regulations 118 (1939 Code), Section 39.23(m)-1, and Treasury Regulations, Sections 1.613-3, 1.613-4, 1.613-5 (26 C.F.R.), are set forth in the Appendix, *infra*, 1a-26a.

STATEMENT

A. The proportionate profits method

Section 611(a) of the Internal Revenue Code of 1954 (App., *infra*, 1a) authorizes a "reasonable allowance for depletion" of natural deposits "in all cases to be made under regulations prescribed by the

Secretary or his delegate." In the case of hard minerals, the allowance is a specified percentage of "gross income from mining." Section 613(a) and (b) of the 1954 Code (App., *infra*, 1a-4a). The rate for calcium carbonate rock, from which cement is made, was 15% for respondent's taxable year ended March 31, 1970, and 14% for its taxable years ended March 31, 1971 and 1972. Section 613(b)(7) of the Code (App., *infra*, 3a-4a).

If a miner simply sells the raw material mined without any further processing, his "gross income from mining" is usually his actual gross receipts from the sales of the raw material. In the case of an integrated miner-manufacturer such as respondent, "gross income from mining" is the miner-manufacturer's constructive income from the raw material product of his mining operations. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86 (1960).

The Treasury Regulations provide two alternative methods for determining the constructive "gross income from mining" of an integrated miner-manufacturer. Under both methods, the constructive figure is derived from actual sales data. If a representative price for the raw material is established by arm's-length sales in a relevant market—by the taxpayer or another miner—that price is the measure of constructive mining income for the raw material which the integrated producer uses in his own manufacturing operations. But if such a representative price cannot be established because the raw material is not generally sold on the open market—as in the integrated cement industry—then the producer's constructive mining income is derived under the proportionate profits method from his own sales price of his manufactured end product.

Under the proportionate profits method, the producer's gross sales receipts are apportioned between mining and total income in the same ratio as the producer's mining costs bear to its overall costs.

The apportionment is reflected in the following equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales of cement} = \text{Gross income from mining}$$

Treasury Regulations, Section 1.613-4(d)(4)(ii) (App., *infra*, 19a-20a).

B. The Facts of this Case and the Proceedings Below

1. Respondent is a Utah corporation which is an integrated miner-manufacturer of Portland cement. For many years, it has engaged in the quarrying of an argillaceous rock, known as cement rock,[1] and the processing of that rock into finished Portland cement (Pet. App. 2a).

The mining phase of respondent's operations begins with the blasting of the cement rock from the face of the mountainous quarry owned by it. The loose rock is then fed through machinery which reduce the material to a size of less than one square inch. After transportation to a processing plant, the material is ground to a high degree of fineness. During the grinding process, water is added to the powder and a very fine mud, known as "slurry," is formed. The slurry is stored in tanks where it is continuously agitated to maintain a uniform texture. The mining

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[1] Cement rock is chemically known as "calcium carbonate," one of the minerals enumerated in Section 613(b)(7) of the 1954 Code.

phase of respondent's operation concludes at this point. Respondent conducts frequent chemical analyses of the slurry to ensure that it is of a proper composition for making Portland cement (Pet. App. 2a-3a).

During the manufacturing phase of respondent's operations, the liquid slurry is fed into rotary kilns and fired. The heat of the kiln expels moisture from the material and converts carbonates to oxides. As the material is heated to the point of fusion, a hard glass-like substance, known as a clinker, is formed. The clinker is thereafter cooled and ground with purchased gypsum to produce finished cement. After the final grinding, respondent places its finished cement in storage silos to await sales to customers (Pet. App. 3a-4a).

During the taxable years at issue, respondent sold its finished cement in two ways, either in bulk or in bags. Most of respondent's output was sold in bulk in tank cars, which were loaded directly from the storage silos. A small portion of the output was run from the storage silos into a bin above a bagging machine where it was sealed in paper bags in which it was thereafter sold (Pet. App. 4a). The parties have stipulated that the "portion of * * * [respondent's] cement sold in bags is the same material as the cement in bulk" (J.A. 40).

2. On its federal income tax returns for the taxable years ended March 31, 1970-1972, respondent computed its "gross income from mining" in accordance with the proportionate profits method set forth in Treasury Regulations, Section 1.613-4(d)(4) (App., *infra*, 19a-23a). This method has been prescribed by successive Treasury Regulations since

1940.[2] It allocates the sales price of the integrated miner-manufacturer's first marketable product between the mining and nonmining phases of its operations in the same ratio that the costs of its mining process bear to its nonmining costs.

On its tax returns for the years in question, respondent took the position that only bulk cement, and not bulk and bagged cement, constituted its first marketable product. It also excluded from the proportionate profits method formula the costs it incurred for storage, distribution and sales. Respondent reported a greater amount of "gross income from mining" (and thereby claimed a greater depletion base) by applying the proportionate profits computation to the gross sales price of its bulk cement and by excluding the costs of bags, bagging, storage, distribution, and sales from the total costs element set forth in the denominator of the prescribed fraction of the formula (see page 3, *supra*) (Pet. App. 6a; J.A. 46, 52, 58-59, 63, 91-93).

3. On audit, the Commisisoner of Internal Revenue determined deficiencies in respondent's tax liabilities. The Commissioner's position is that: (1) ce-

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[2] See Treasury Regulations 103 (1939 Code), Section 19.23(m)-1(f); Treasury Regulations 111 (1939 Code), Section 29.23(m)-1(f); Treasury Regulations 118 (1939 Code), Section 39.23(m)-(e)(3) (App., *infra*, 5a-7a, 22a-24a). The cited provision of Treasury Regulations 118 continued in force under the 1954 Code (pursuant to Section 7807 of that Code (26 U.S.C.) (see T.D. 6091, 1954-2 Cum. Bull. 47) (Aug. 16, 1954)) until superseded by Section 1.613-3(d)(1)(i) and (ii) of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) (see T.D. 6965, 1968-2 Cum. Bull. 265 (July 26, 1968)). These Regulations were, in turn, superseded by Section 1.613-4(d)(1) and (4)(i) and (ii) of the Treasury Regulations on Income Tax (1954 Code) (see T.D. 7170, 1972-1 Cum. Bull. 178 (Mar. 15, 1972)).

ment, whether sold in bulk or in bags, constituted respondent's first marketable product, and (2) the costs of bags, bagging, storage, distribution and sales were includable in the "total costs" element in the formula. The Commissioner's computation yielded a greater "total costs" figure, and consequently a reduced amount of "gross income from mining" and a correspondingly smaller depletion base (Pet. App. 1a-2a, 6a; J.A. 16-30, 82-90, 94-99).

Respondent thereafter brought this suit in the Tax Court for redetermination of the deficiencies. The Tax Court upheld respondent's computation and correspondingly larger depletion deduction. Invoking the *Golsen* rule,[3] pursuant to which it follows the law of the circuit to which a case would be appealed, the Tax Court concluded that it was bound by *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), cert. denied, 395 U.S. 936 (1969) (Black and Harlan, JJ., dissenting; White and Marshall, JJ., not participating), rehearing denied, 396 U.S. 975 (1969); and *Portland Cement Co. of Utah* v. *United States*, 412 F.2d 894 (10th Cir. 1969). In so holding, the Tax Court rejected the Commissioner's argument that the Tenth Circuit in *Ideal Basic Industries* never considered the Treasury Regulations explicitly classifying the costs of bags, bagging, storage, distribution, and sales as nonmining costs. Accordingly, the Commissioner urged that the *Golsen* rule was inapplicable because the premises underlying the Tenth Circuit's earlier decisions were not valid (Pet. App. 8a-11a).

The court of appeals affirmed (Pet. App. 12a-17a), noting that "[w]e can add little, if anything, to

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[3] See *Golsen* v. *Commissioner*, 54 T.C. 742 (1970), aff'd on other issues, 445 F.2d 985 (10th Cir.), cert. denied, 404 U.S. 940 (1971).

the analysis made by the Tax Court" (Pet. App. 13a-14a). In so ruling, it considered dispositive its earlier decision in *Ideal Basic Industries*, that " 'bulk cement' is marketable as such, and that under the Regulations it is the 'first marketable product.' The bagged cement is the next stage, and it is, as the Tax Court indicated, the second marketable product" (Pet. App. 14a-15a).

Adhering to the *Ideal Basic Industries* rationale, the court of appeals also rejected the Commissioner's argument that the cement in the bags is the same product as the cement in the bulk silos and his reliance upon the governing Treasury Regulations, Section 1.613-4 (d)(4)(iv) (App., *infra*, 21a-22a). That Regulation explicitly provides that "bulk and packaged products are considered to be essentially the same product." As the court saw the matter, "[i]t is obvious that both are 'cement,' but it is equally apparent that it is 'first marketable' as bulk cement, not as bagged cement" (Pet. App. 15a).

The court of appeals also affirmed the Tax Court's exclusion of respondent's bags, bagging, storage, distribution and sales costs from the "total costs" element in the proportionate profits formula. In support of this aspect of its holding, it adhered to its prior ruling in *Ideal Basic Industries* that "the costs of bagging and of bags were *not* mining costs, and should be excluded under an application of the proportionate costs doctrine" (Pet. App. 15a; emphasis in original). In its view, "[t]hese costs thus had no part there in the determination of the income from the first marketable product. They have no part here when *Ideal Basic* is applied" (*ibid.*).

SUMMARY OF ARGUMENT

1. If a miner does not conduct manufacturing operations with the mineral he extracts from the earth, his "gross income from mining," from which his percentage depletion deduction is derived, is usually his actual gross receipts from the sales of the raw mineral. But in the case of an integrated miner-manufacturer—one who does not sell the raw material he mines, but uses it in his own manufacturing operations—"gross income from mining" is the manufacturer's constructive income from the raw material product of his mining operations.

Section 611(a) of the Code allows a reasonable allowance for depletion "in all cases to be made under regulations prescribed by the Secretary or his delegate." Thus, the Treasury Regulations in the depletion area were issued pursuant to an express congressional authorization to deal with "the multifarious circumstances which would involve questions of depletion." *Douglas* v. *Commissioner*, 322 U.S. 275, 281 (1944). As the Court has long recognized, such Regulations are legislative in character and are therefore entitled to deference similar to that accorded the statute itself. *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501 (1948).

Since 1940, the Regulations have provided for the use of a proportionate profits method to compute the depletion deduction of an integrated miner-manufacturer under circumstances where there is no representative (arm's-length) price for the raw material mined. Under that method gross income from mining is computed in accordance with the following equation:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales of manufactured product} = \text{Gross income from mining}$$

The central premise of the method is that every dollar of the total costs of mining and nonmining earns its proportionate part of the total profits, and consequently its proportionate part of gross sales.

The objective of the proportionate profits method is to identify the portion of an integrated producer's gross sales that has been produced by the costs of his mining operations; that portion is the producer's constructive mining income. In substance, the method apportions gross sales receipts of the producer's first marketable product between mining and total income in the same ratio that the producer's mining costs bear to its total costs. By limiting the "gross sales" element to the proceeds derived from sales of the "first marketable product," the formula properly excludes income derived from manufacturing operations which "destroy the physical or chemical identity of the minerals or permit them to be transformed into new products" (*United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86 (1960)). Because such manufacturing income is entirely unrelated to mining, it has no place in a formula designed to measure depletable gross income.

2. a. This case involves two questions relating to the application of the proportionate profits method to an integrated miner-manufacturer of cement.

The court of appeals first ruled that respondent's "gross sales of cement" should be determined on the assumption that its first marketable product was cement sold in bulk, rather than in bulk and in bags, as

was in fact the case. In so holding, the court adhered to its prior decisions in *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), cert. denied, 395 U.S. 936 (1969) (Black and Harlan, JJ., dissenting, White and Marshall, JJ., not participating), rehearing denied, 396 U.S. 975 (1969); and *Portland Cement Co. of Utah* v. *United States*, 412 F.2d 894 (10th Cir. 1969).

But the conclusion that cement in bulk is a qualitatively different product from cement sold in bags materially distorts the application of the proportionate profits method. Under that method, respondent's first marketable product is unquestionably finished Portland cement, the end result of its combined mining and manufacturing operations. Bulk cement and cement sold in bags is plainly the same product. Indeed, the parties have so stipulated (J.A. 40). The container for that product—whether it be a tank car supplied by the customer or a bag supplied by the respondent—does not alter the physical or chemical characteristics of the cement. Since the proportionate profits method requires an allocation of the actual gross receipts received on the sale of that production, that allocation must be determined solely on the basis of the prices in fact charged for the commodity regardless of variations in packaging. The pertinent Regulations (Section 1.613-4(d)(4)(iv)), which must be accorded great weight, explicitly state that "bulk and packaged products are to be considered essentially the same product" and provide a specific reference to the cement industry that covers this case. Accordingly, the exclusion from gross sales of any part of the sales proceeds of any cement will not yield the correct amount of gross income from mining under the proportionate profits formula.

b. The Tenth Circuit's decision in *Ideal Basic Industries*, which it followed in the instant case, stands alone as the only appellate authority to reject the direction of the Regulations defining "first marketable product" generally, and particularly in the case of cement. Prior to that decision, the Third Circuit in *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (1966), had upheld the inclusion of bagged cement in the first marketable product. Moreover, since *Ideal Basic Industries*, the Ninth Circuit in two separate cases and the Fifth Circuit have explicitly rejected the Tenth Circuit's rationale that bagged cement is a separate or different product. The contrary holding of the Tenth Circuit defies the laws of chemistry and is without logical basis.

3. The decision below likewise erred in excluding respondent's post-manufacturing costs of bags, bagging, storage, distribution and sales from the "total costs" denominator element of the formula. Here again, the court of appeals stands alone as the only circuit adhering to this view, which is at odds with the explicit direction of the pertinent Treasury Regulations. The Third, Fourth, Fifth, and Ninth Circuits have correctly upheld the inclusion of these post-manufacturing costs in the formula in accordance with the Regulations. The Court of Claims has also sustained the Commissioner's position.

It is undisputed that these costs are non-mining costs and therefore part of the total costs. Indeed, the court below so acknowledged (Pet. App. 15a). The Tenth Circuit's exclusion of these costs from the formula is a consequence of its erroneous initial holding that the first marketable product was bulk cement. It therefore concluded that all of the expenses incurred after the production of bulk cement "are not a proper part of the computation." *United States* v. *Ideal Basic Industries*, *supra*, 404 F.2d at 126.

But no expenses incurred in producing and selling the first marketable product may be eliminated from the proportionate profits formula without compromising the integrity of its underlying accounting theory of allocating gross sales in accordance with the ratio of mining costs to *total* costs. To exclude the post-manufacturing costs of bags, bagging, storage, distribution and sales from the formula is in effect to put part of these costs and their allocable share of profits within the depletion base. As the dissenting judge observed in *Ideal Basic Industries*, in terms that are equally applicable here, this decision "reaches a result that is a rejection of the basic theory of the proportionate profit method itself" (404 F.2d at 127).

ARGUMENT

ALL OF RESPONDENT'S POST-MANUFACTURING COSTS INCURRED IN DISTRIBUTING AND SELLING ITS CEMENT MUST BE INCLUDED IN THE "TOTAL COSTS" OF THE PROPORTIONATE PROFITS FRACTION FOR COMPUTING ITS DEPLETABLE "GROSS INCOME FROM MINING" BECAUSE ITS FIRST MARKETABLE PRODUCT IS CEMENT, WHETHER SOLD IN BULK OR IN BAGS

A. The Theory of the Proportionate Profits Method Requires that Every Dollar of Costs that Produces Gross Sales Must Enter Into the Computation and that Every Dollar of Such Costs Produces the Same Percentage of Profits

Section 611(a) of the Internal Revenue Code of 1954 (App., *infra*, 1a) provides in pertinent part that in "the case of mines, * * * [and] other natural deposits, * * * there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * *, according to the peculiar

conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate." In the case of hard minerals, the allowance is a specified percentage of "gross income from mining." Section 613(a) and (b) of the 1954 Code (App., *infra*, 1a-2a).[4] As this Court has declared on many occasions, the depletion allowance "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956); *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366 (1938); *Parsons* v. *Smith*, 359 U.S. 215, 220 (1959); *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86 (1960); *Anderson* v. *Helvering*, 310 U.S. 404, 408 (1940).

If a miner does not conduct manufacturing operations, *i.e.*, if he does not "destroy the physical or chemical identity of the minerals or permit them to be transformed into new products" (*United States* v. *Cannelton Sewer Pipe Co.*, *supra*, 364 U.S. at 86), his "gross income from mining" is usually his actual gross receipts from the sales of the raw material. In the case of an integrated producer such as respondent—one who does not sell the raw material he mines, but uses it in his own manufacturing operations—"gross income from mining" is the producer's

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[4] The rate for calcium carbonate rock, from which cement is made, was 15% for respondent's taxable year ended March 31, 1970, and 14% for its taxable years ended March 31, 1971 and 1972. Section 613(b)(7) (App., *infra*, 2a-4a).

gross income constructively attributed to the raw mineral product of his mining operations (*ibid.*).[5]

Since 1940, the Treasury Regulations (now embodied in Section 1.613-4(c)(1) and Section 1.613-4 (d)(1)(i) and (3) (26 C.F.R.)) have provided two different methods for determining the constructive "gross income from mining" of an integrated miner-manufacturer. Under each method, the constructive figure is derived from proceeds attributable to the integrated miner's raw material product. As we have explained (*supra*, page 2), the taxpayer can, if circumstances warrant, employ a representative price as the measure of his constructive mining income for the raw material that the integrated producer uses in his own manufacturing operations. However, respondent, and the members of the integrated cement industry, were not able to establish a representative price because the raw material they use is not generally sold on the open market. Hence, respondent computed its constructive mining income under the proportionate profits method from his gross income from sale of the manufactured end product.

The objective of the proportionate profits method is to identify the portion of an integrated producer's gross sales that has been produced by the costs of his mining operations. That portion is the producer's constructive gross income from mining and the depletion base against which the depletion allowance is claimed. Accordingly, the method apportions gross

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[5] Under Section 613(c)(2) and (c)(4)(F) of the Code (App., *infra*, 4a-5a), in the case of an integrated miner-manufacturer of cement, the "mining" process terminates with the preparation of kiln feed and its transportation to the mouth of the kiln. The kiln firing process and subsequent operations are nonmining processes.

sales receipts between mining and nonmining income in the same ratio that the producer's mining costs bear to its nonmining costs.

The apportionment is reflected in the following equation: [6]

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales of cement} = \text{Gross income from mining}$$

Treasury Regulations, Section 1.613-4(d)(4)(ii) (App., *infra*, 19a-20a).[7]

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[6] This equation was first set forth in Section 1.613-3(d)(1)(ii), Treasury Regulations on Income Tax (1954 Code), on July 25, 1968. T.D. 6965, 1968-2 Cum. Bull. 265. Several courts had decided that the same equation was applicable under Section 39.23(m)-1(e)(3) of Treasury Regulations 118 (1939 Code) (App., *infra*, 6a-7a). See, *e.g.*, *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468, 471 (3d Cir. 1966); *Riddell* v. *California Portland Cement Co.*, 330 F.2d 16, 17 (9th Cir. 1964); *General Portland Cement Co.* v. *United States*, 628 F.2d 321 (5th Cir. 1980).

[7] The "proportionate profits" method of determining "gross income from mining," now set forth in Treasury Regulations, Section 1.613-4(d)(4), first appeared in 1940 in Treasury Regulations 103 (1939 Code), Section 19.23(m)-1(f). It might then and now have been referred to with equal accuracy and greater clarity as the proportionate *proceeds* method because, as the Tax Court aptly stated, "[t]he purpose of the proportionate-profits formula is to separate the sales price of a product into its mining and nonmining components." *North Carolina Granite Corporation* v. *Commissioner*, 56 T.C. 1281, 1291 (1971). Profits, as such, have little or no relevance in this context. If, however, one makes the assumption on which the formula is based, that profits from mining and from nonmining operations are in the same ratio as mining costs and nonmining costs, then mining costs plus mining profits will yield proceeds from mining, or "gross income from mining."

The basic theory of the method is that every dollar of the producer's costs, mining and nonmining alike, is deemed to produce the same proportionate part of the proceeds from sales of the first marketable product; it is the gross receipts from such sales that are apportioned in accordance with the cost ratio. Treasury Regulations, Section 1.613-4(d)(4)(i) (App., *infra*, 19a). As the Court of Claims correctly observed in *Standard Lime and Cement Co.* v. *United States*, 329 F.2d 939, 944 (1964): "[E]ach dollar of costs expended to *produce and sell* the end product earns the same percentage of the profit" (emphasis supplied). The pertinent Treasury Regulation (Section 1.613-4(d)(4)(i)) (App., *infra*, 19a) therefore provide: "Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products." The premise that every dollar of costs produces the same ratable part of the proceeds is in accord with long-settled principles of corporate accounting. See Paton and Littleton, *An Introduction to Corporate Accounting Standards* 67 (American Accounting Association 1940).

Two fundamental principles therefore emerge with respect to the allocation of gross sales between mining and nonmining income under the proportionate profits method. First, every dollar of costs that has produced gross sales must enter into the computation. Second, every dollar of such costs is deemed to earn the same percentage of gross sales. No expenses may be eliminated from the proportionate profits method, for the underlying accounting theory of that method is abrogated unless a producer's gross sales

are allocated in accordance with a cost fraction which includes in its denominator *all* of the costs producing the sales.

The determination of the integrated miner-manufacturer's "gross income from mining" requires an allocation of all its income from sales of the first marketable product between the mining and nonmining phases of the company's operations. All costs and all of the profit must be allocated to either the mining or the nonmining part of the operation. If an item of expense in fact results from the mining phase of the business, it should be included in the "gross income from mining," and also carry into "gross income from mining" its ratable share of the company's profit or loss. By the same token, every cost that is attributable to the nonmining operations, together with its allocable share of profit or loss, must be excluded from the depletion base by adding it to the denominator of the fraction "Total costs." If nonmining costs are not so added to the denominator of the formula, the proportionate profits formula will be distorted and the depletion allowance will thereby not be restricted to its intended scope—the return of the miner's capital interest in depletable minerals.

B. Respondent's first marketable product is cement, whether sold in bulk or in bags

1. Once it is recognized that the integrity of the proportionate profits method requires the inclusion in the formula on an equal basis of all costs incurred to produce the first marketable product, the error of the decision below becomes apparent. The court of appeals here ruled that respondent's gross sales of cement should be determined on the assumption that all its cement was sold in bulk, rather than in bulk and in bags (Pet. App. 14a-15a).

But the conclusion that cement in bulk is a qualitatively different product from cement sold in bags and is therefore respondent's first marketable product materially distorts the application of the proportionate profits method. Under that method, the nature of the first marketable product depends upon its physical and chemical characteristics. See *United States* v. *Cannelton Sewer Pipe Co.*, *supra*, 364 U.S. at 85-86. Neither the quantities nor the packages in which it is sold, and which determine the per unit price, affect the nature of the product. Cement sold in bulk and cement sold in bags are unquestionably the same product. The container for that product—whether it be a tank car supplied by the customer or a bag supplied by respondent—does not alter the physical or chemical characteristics of the cement. Indeed, the parties have stipulated that bulk and bagged cement is the same product (J.A. 40). The proportionate profits method requires an allocation of the actual gross receipts received upon the sale of that product, and that must be determined solely on the basis of the prices in fact charged for the commodity regardless of variations depending upon such things as packaging. To exclude from gross sales any part of the sales proceeds of any cement will not yield the correct amount of gross income from mining under the proportionate profits formula upon which the statute allows percentage depletion.

2. The foregoing analysis is squarely supported by the terms of the governing Treasury Regulations, which define first marketable product with particular reference to the cement industry. Sections 1.613-3(d)(1)(iv) and 1.613-4(d)(4)(iv) of the Regulations (App., *infra*, 8a, 21a) provides that the term "first marketable product" means "the product * * * pro-

duced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayers' marketing area." The Regulation further states that "For this purpose, bulk and packaged products are considered to be essentially the same product." Finally, in terms explicitly directed to the question presented in this case, the Regulation illustrates the definition with the following example: "* * * [I]f a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him."

As we have noted at the outset of our argument (*supra*, pages 12-15), Section 611(a) of the Code authorizes a reasonable allowance for depletion with the proviso that "such reasonable allowance in all cases [is] to be made under regulations prescribed by the Secretary or his delegate." See also 26 U.S.C. 7805(a). Thus, the Regulations upon which we rely are legislative in character insofar as they were issued pursuant to an express congressional authorization to deal with what this Court has described as "the multifarious circumstances which would involve questions of depletion * * *." *Douglas* v. *Commissioner*, 322 U.S. 275, 281 (1944). As the Court has long recognized, such legislative Regulations are entitled to deference similar to that accorded the Code itself unless deemed to be contrary to the statutory authorization or unreasonable. *Com-*

missioner v. *South Texas Co.*, 333 U.S. 496, 501 (1948). Such Regulations therefore have the force and effect of law and "will not be overruled except for weighty reasons." *Fawcus Machine Co.* v. *United States*, 282 U.S. 375, 378 (1931). See also *Brewster* v. *Gage*, 280 U.S. 327, 336 (1930). Indeed, the legislative delegation and deference to the "masters of the subject" (*United States* v. *Moore*, 95 U.S. 760, 763 (1878)) in the depletion area is particularly appropriate. In this context, the Court has recognized a special need for broad discretion by those charged with the administration of the tax law. "[T]he highly technical and involved factors entering into a practical solution of the problem of depletion in administration of the tax laws points to the necessity of interpreting * * * [the applicable statute] so as to strengthen rather than to weaken the administrative powers to deal with it equitably and reasonably." *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90, 103 (1939).

2. Given the explicit command of the Regulations that respondent's first marketable product is cement, whether sold in bulk or in bags, and the consistency of that definition with the purpose of the proportionate profits method, it is hardly surprising that apart from the court below, every other court of appeals has sustained the Commissioner's definition of first marketable product as finished cement, in bulk and bags. Indeed, in *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (1966), the Third Circuit upheld the Commissioner's position even prior to the 1968 promulgation of the definition of "first marketable product" in the Treasury Regulations. There, the taxpayer likewise argued that the costs incident to and premiums charged for cement sold in bags should be excluded from the proportionate

profits calculation, on the theory that the bagging costs were more than the premium so that those costs could not fairly be considered to have produced a proportionate share of the manufacturer's overall profits. The court rejected this argument as resting on (369 F.2d at 474) "an erroneous assumption that the packaging costs produced only the additional revenue derived from the premiums * * *. It seems reasonable to infer that the profits realized from the sale of packaged cement, and these were substantial, were attributable at least in part to the packaging costs." The court therefore held that the packaging costs must be included in the denominator of the proportionate profits equation as a nonmining cost and that the profits attributable to such costs should be included in gross sales (*ibid.*).

Similarly, in *United States* v. *California Portland Cement Co.*, 413 F.2d 161 (1969), the Ninth Circuit held that the first marketable product was finished cement, regardless of the form of its packaging. There, as here, the taxpayer argued that its profits resulting from sales of bagged cement should be excluded from the proportionate profits formula on the ground that the first marketable product obtained from the calcium carbonate rock was bulk cement. But the Ninth Circuit rejected this contention, citing with approval the explicit direction of Treasury Regulations, Section 1.613-3(d)(1)(iv) (App., *infra*, 8a) that "bulk and packaged products are considered to be essentially the same product" and that with respect to a cement manufacturer, "the finished cement of various types, *in bulk and bags*, constitutes the first marketable product or group of products produced by him" (emphasis added).

In so ruling, the Ninth Circuit observed (413 F.2d at 169) that the treatment of bag and bagging costs by the court below in *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), cert. denied, 395 U.S. 936 (1969) (Black and Harlan, JJ., dissenting, White and Marshall, JJ., not participating), rehearing denied, 396 U.S. 975 (1969), was not consistent "with other language of that opinion * * *" that states that " 'the sales price of the first marketable product is to be computed on the identical physical material that is represented by total mining and non-mining costs' " (404 F.2d at 125 n.1). Moreover, the Ninth Circuit (413 F.2d at 170) agreed with the conclusion of the dissenting judge in *Ideal Basic* that "[t]o eliminate all post-manufacturing costs destroys consideration of the representative market or field price of the first marketable product, a prime factor in the application of the equation, and thus seems * * * to reject the method itself" (404 F.2d at 128).[8]

Finally, most recently in *General Portland Cement Co.* v. *United States*, 628 F.2d 321 (1980), the Fifth Circuit has likewise upheld the Commissioner's position that the first marketable product in these cases is finished cement, whether in bulk or bagged form. In so holding, the court rejected the "simple logic" of *Ideal Basic*, to which the court below adhered, that "Bulk cement is the first marketable

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[8] The Ninth Circuit's decision in *California Portland Cement Co.* was issued on June 4, 1969, two days after this Court denied certiorari in *Ideal Basic Industries*. Although we called the attention of the Court to that decision in a petition for rehearing in *Ideal Basic Industries*, the Court denied rehearing (396 U.S. 975 (1969) (White and Marshall, JJ., not participating)).

product because it *can* be sold" (404 F.2d at 126 n.2) (emphasis in original) and that "bagged cement is the second marketable product (footnote omitted)" (*id.* at 126). As the Fifth Circuit correctly responded, "Even if we assume, with those cases, that bulk cement is the first marketable product, it does not follow therefrom that bagged cement is a separate or different product. That is, it does not follow that bagged cement is the second marketable product. Rather, bagging is simply a way of getting the same product, namely cement, to market. Some customers might want cement in rail cars, some in trucks, some in barges, some in 'piggy-back' containers, and some in bags. The product, however, remains cement (footnotes omitted)." 628 F.2d at 332-333.[9]

It is therefore clear that the additional gross sales received by respondent from the premium it charged for bagged cement must be included in the "gross sales" figure of the proportionate profits formula. The act of putting finished cement in a bag is not a nonmining process that alters the chemical form or condition of the cement. There is accordingly no difference between bulk and bagged cement for purposes of determining the proceeds derived from sales of respondent's first marketable product. Under the proportionate profits formula, "gross sales" of the

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[9] The district court's opinion in that case (*General Portland Cement Co.* v. *United States*, 438 F. Supp. 27, 35 (N.D. Tex. 1977)) put it much the same way. It stated: "To say that the cement in the truck and barge is the first marketable product is to defy the reality of the marketing process. Both large and small orders are sold as cement; the only difference between the two methods of sale is how the customer receives his cement. Different legal results which depend upon the mere size of the order of cement are simply not rational."

first marketable product for the cement industry must therefore mean gross sales of finished cement, whether in bulk or in bags.

C. The post-manufacturing costs of bags, bagging, storage, distribution and sales should be included in the proportionate profits formula as nonmining costs

It is undisputed that the costs of storing, shipping, bagging and bags are nonmining costs because they are not related to mining operations.[10] The Treasury Regulations (Sections 1.613-4(d)(3)(i) and (iii), 1.613-4(g)(3) and (4)) (App., *infra*, 16a-18a, 24a-25a), so provide;[11] and the court below (Pet. App. 15a) as well as the other courts have so held.[12] With respect to selling expenses, the Treasury Regu-

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[10] Section 613(c)(4)(F) provides that mining includes all processes up to kiln feed "but not including any subsequent process." Subsequent manufacturing and marketing processes are excluded under the statutory scheme. Only those cost items incurred in the processes up to kiln feed may be considered a mining cost. Costs incurred in manufacturing and marketing processes are therefore nonmining costs. The statutory definition is in accord with the basic purpose of the depletion allowance to compensate for the exhaustion of the mineral assets, rather than for the cost of manufacturing and marketing of the end product. *General Portland Cement Co.* v. *United States*, *supra*, 628 F.2d at 323-335, *Standard Lime and Cement Co.* v. *United States*, *supra*, 329 F.2d at 946, 948.

[11] Sections 1.613-3(d)(4)(i) and (iii) and 1.613-4(g)(3) of the Treasury Regulations on Income Tax (26 C.F.R.) (1968) (App., *infra*, 10a-12a, 24a-25a) are substantially the same as Sections 1.613-4(d)(3)(i) and (iii) and 1.613-4(g)(3) of the Treasury Regulations on Income Tax (26 C.F.R.) (1972) (App., *infra*, 16a-18a, 24a-25a).

[12] *General Portland Cement Co.* v. *United States*, *supra*, 628 F.2d at 330-335 (costs of bags, bagging, loading and storing); *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 167-170 (costs of bags and bag-

lations (Section 1.613-4(d)(3)(iv) and 1.613-5(c)(4)(ii)) (App., *infra*, 18a-19a, 26a) provide that they are non-mining costs except when a taxpayer shows that a nonintegrated miner or producer typically incurs selling expenses, in which case such expenses are allocated between mining and nonmining costs. Respondent, however, made no such showing in this case. Accordingly, the courts below correctly held them to be nonmining costs.[13] The only question is whether

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ging); *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508-510 (9th Cir. 1970) (costs of shipping, bags and bagging); *Whitehall Cement Manufacturing Co.* v. *United States, supra*, 369 F.2d at 473-474 (costs of bags, bagging and bulk loading); *Standard Lime and Cement Co.* v. *United States, supra*, 329 F.2d at 948-950 (costs of containers, packing, loading and storing); *Mississippi Valley Portland Cement Co.* v. *United States*, 347 F. Supp. 240 (S.D. Miss. 1972) (costs of shipping, marketing and packaging).

[13] Prior to the issuance of the 1972 Treasury Regulations, there was no Regulation resolving the question whether selling expenses were nonmining costs or allocable between mining and nonmining costs. The Commissioner consistently took the position that selling costs were nonmining costs because they were entirely associated with the distribution of finished cement. The Tenth Circuit in *Ideal Basic Industries, supra*, 404 F.2d at 126-127, the Court of Claims in *Standard Lime, supra*, 329 F.2d at 946-947, and the district court in *Mississippi Valley Portland Cement Co., supra*, 347 F. Supp. at 243, all agreed with the Commissioner that selling costs were nonmining costs. On the assumption that nonintegrated miners incur selling expenses, the Ninth Circuit in *California Portland Cement, supra*, 413 F.2d at 170-172, and *Southwestern Portland Cement Co., supra*, 435 F.2d at 508-509, and the Fourth Circuit in *Arvonia-Buckingham Slate Co.*, 426 F.2d 484, 486-487 (1970), held that selling expenses were to be apportioned between mining and nonmining costs. These decisions are not inconsistent with the 1972

these nonmining costs are included as such in the proportionate profits computation.

Just as it does with respect to the first issue, the court below stands alone as the only circuit excluding the post-manufacturing costs of bags, bagging, storage, distribution and sales from the proportionate

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Regulations, but merely assume a fact that these Regulations require the taxpayer to prove.

At all events, the 1972 Regulations are applicable in this case. Those Regulations are applicable by their terms to all years governed by the 1954 Code. T.D. 7170, 1972-1 Cum. Bull. 178. Because they were promulgated prior to the end of respondent's taxable year ended March 31, 1972, there is no issue of retroactivity with respect to that year. Moreover, the 1972 Regulations can apply retroactively to respondent's taxable years ended March 31, 1970 and 1971. As a general rule, Treasury Regulations are applicable retroactively to cover all years governed by the statute under which they are promulgated, as long as they do not contravene the statute or well-settled law. *Dixon* v. *United States*, 381 U.S. 68, 71-75 (1965); *Automobile Club* v. *Commissioner*, 353 U.S. 180, 184 (1957); *Helvering* v. *Reynolds*, 313 U.S. 428, 432-433 (1941); *Manhattan Co.* v. *Commissioner*, 297 U.S. 129, 134-135 (1936); *United States* v. *California Portland Cement Co., supra*, 413 F.2d at 164; *Anderson, Clayton & Co.* v. *United States*, 562 F.2d 972, 976 (5th Cir.), rehearing and rehearing en banc denied, 565 F.2d 1215 (1977), cert. denied, 436 U.S. 944 (1978); *Wilson* v. *United States*, 588 F.2d 1168, 1171 (6th Cir. 1978). The Regulations merely set forth a specific application of the proportionate profits method as it relates to selling expenses. The selling costs are clearly nonmining expenses to the extent that nonintegrated miners had no selling expenses. Without evidence to the contrary, selling expenses are costs incurred in selling the finished cement, not the kiln feed, and are therefore nonmining costs. The allocation of these expenses to nonmining costs, absent proof that nonintegrated miners incur selling costs, correctly restricts the depletion base to the statutory "gross income from mining."

profits computation. All of the other courts of appeals that have considered the question have held that a proportionate part of the profits from the sale of the first marketable product is allocable to these nonmining costs so that they should be included in the proportionate profits formula. *General Portland Cement Co.* v. *United States, supra,* 628 F.2d at 330-335 (costs of bags, bagging, loading and storing). *United States* v. *California Portland Cement Co., supra,* 413 F.2d at 167-172 (costs of bags, bagging, and sales) and *Southwestern Portland Cement Co.* v. *United States,* 435 F.2d 504, 508-510 (9th Cir. 1970) (costs of shipping, bags and bagging and selling); *Arvonia-Buckingham Slate Co.* v. *United States,* 426 F.2d 484 (4th Cir. 1970) (costs of advertising and sales); *Whitehall Cement Manufacturing Co.* v. *United States, supra,* 369 F.2d at 468 (costs of bags, bagging, and bulk loading). See also *Standard Lime & Cement Co.* v. *United States, supra,* 329 F.2d at 939 (costs of containers, packing, loading and storing).[14]

Here, as in its previous decision in *Ideal Basic Industries,* the court below refused to recognize that all of the costs of producing and selling cement had

[14] In *Standard Lime & Cement Co.* v. *United States,* 329 F.2d 939 (1964), the Court of Claims employed a computational approach different from the ratio formula set forth in the current Regulations and adopted by other courts under Treasury Regulations 118. This approach achieves the same end result, however, because the same basic theory was applied. *Standard Lime* reflects the literal description of the proportionate profits method in the 1939 Code Regulations. Under that description, post-manufacturing costs, together with their proportion of the profits, are subtracted from gross sales. This manner of working back from gross sales maintains the proper correspondence between a constructive income figure and related costs at any point in an integrated producer's operations. See the detailed discussion of *Standard Lime* in *General Portland Cement Co.* v. *United States, supra,* 628 F.2d at 328-329.

to be taken into account in determining the costs ratio. It correctly reaffirmed its prior holding that "the costs of bagging and of bags were *not* mining costs * * *" (Pet. App. 15a). But it erroneously refused to apply the basic theory of the proportionate profits method to these costs, in holding that they "should be excluded under an application of the proportionate costs doctrine" (*ibid.*).

By excluding these costs from the denominator (total costs) of the fraction

$$\frac{\text{Mining costs}}{\text{Total costs}}$$

(against which gross sales must be multiplied), the decision below has likewise invalidated Treasury Regulations of a legislative character that are, as we have explained (*supra*, pages 19-20), entitled to great deference. Those Regulations (Sections 1.613-4(d)(3)(i), (iii), and (iv), 1.613-4(g)(3) and (4) (App., *infra*, 16a-19a, 25a-26a) explicitly require that these post-manufacturing costs shall be considered as nonmining costs and that "all profits attributable thereto are treated as nonmining profits" (App., *infra*, 18a-19a).[15] Indeed, as we have pointed out (*supra* page

[15] Both the Tax Court (Pet. App. 9a, 11a) and the court of appeals (Pet. App. 15a) rejected the Commissioner's argument that the Tenth Circuit in *Ideal Basic Industries* never addressed the Regulations that specifically classify bags and bagging costs as nonmining costs and that this error required a reconsideration of that decision. In response, both courts below cited the fact that *Ideal Basic Industries* did not dispute the proposition that the costs of bags and bagging constitutes nonmining expenses (see 404 F.2d at 125). But this conclusion overlooks the further command of the Regulation that "all profits attributable (to nonmining costs such as bags and bagging) be treated as nonmining profits" (App., *infra*, 18a) and must be thereby excluded from the depletion base.

17), no expenses may be eliminated from the proportionate profits formula without compromising the integrity of its underlying theory of allocating gross sales in accordance with the ratio of mining costs to *total* costs. The post-manufacturing costs of bags, bagging,[16] storage, distribution and sales are unquestionably part of total costs. To exclude them from the formula is in effect to put part of the post-manufacturing costs and their allocable share of profits within respondent's depletion base. This distortion is a consequence of the court's requiring the allocation of sales income (erroneously limited to bulk cement) by a ratio that includes only mining and manufacturing costs in the denominator. As the dissenting judge observed in *Ideal Basic Industries*, in terms that are equally appropriate here, this decision "reaches a result that is a rejection of the basic theory of the proportionate profit method itself" (404 F.2d at 127). Accord: *California Portland Cement Co.* v. *United States*, *supra*, 413 F.2d at 169-170, 172; *General Portland Cement Co.* v. *United States*, *supra*, 628 F.2d at 330. The court of appeals' persistent rejection of the basic theory of this well-established method of computing the depletion deduction should be corrected by this Court.

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[16] The fact that the costs of bags and bagging exceeded the premium charged for them (J.A. 102, 105) does not mean that they did not contribute to respondent's profit on the sale of cement. Both the Third Circuit in *Whitehall* (369 F.2d at 474) and the Fifth Circuit in *General Portland* (628 F.2d at 330-331) also concluded that it was reasonable to infer that an integrated miner-manufacturer's sale of bagged cement was an accommodation to customers, induced such sales, and at least partially contributed to substantial profits. Indeed, there is no need even to make such an inference in this case for the parties have stipulated that respondent "realized a net profit on the sale of each bag of cement" (Supp. Stip. ¶ 4; J.A. 103).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * * *

SEC. 613. PERCENTAGE DEPLETION.

(a) [as amended by Section 13(e), Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960] *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section

611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*— * * *

* * * * *

(7) [as amended by Section 302(a), Public Debt and Tax Rate Extension Act of 1960, Pub. L. No. 86-564, 74 Stat. 290; Section 6(a), Act of September 2, 1964, Pub. L. No. 88-571, 78 Stat. 857; Sections 208(a) and 209(a), Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539. In effect for tax years beginning on or prior to October 9, 1969.] 15 percent—[a]ll other minerals (including, but not limited to, aplite, barite, borax, calcium carbonates, di-

atomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(C) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc, including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water, or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

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(7) [as amended by Section 501(a), Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487; Section 501(b)(2), Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26. In effect for tax years beginning after October 9, 1969.] 14 percent—[a]ll other

minerals, including, but not limited to, aplite, barite, borax, calcium carbonates, diatomaceous earth, dolomite, feldspar, fullers earth, garnet, gilsonite, granite, limestone, magnesite, magnesium carbonates, marble, mollusk shells (including clam shells and oyster shells), phosphate rock, potash, quartzite, slate, soapstone, stone (used or sold for use by the mine owner or operator as dimension stone or ornamental stone), thenardite, tripoli, trona, and (if paragraph (1)(C) does not apply) bauxite, flake graphite, fluorspar, lepidolite, mica, spodumene, and talc (including pyrophyllite), except that, unless sold on bid in direct competition with a bona fide bid to sell a mineral listed in paragraph (3), the percentage shall be 5 percent for any such other mineral (other than slate to which paragraph (5) applies) when used, or sold for use, by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. For purposes of this paragraph, the term "all other minerals" does not include—

(A) soil, sod, dirt, turf, water or mosses; or

(B) minerals from sea water, the air, or similar inexhaustible sources.

(c) [as amended by Section 302(b)(1) and (2), Public Debt and Tax Rate Extension Act of 1960, *supra*] *Definition of Gross Income From Property.*—For purposes of this section—

(1) *Gross income from the property.*—The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) *Mining.*—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * * *

(4) *Treatment processes considered as mining.*—* * *

* * * * *

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln food into the kiln, but not including any subsequent processes;

* * * * *

Treasury Regulations 118 (1939 Code):

§ 39.23(m)-1 *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*

* * * * *

(e) As used in sections 114(b)(3) and 114(b)(4)(A) and §§ 39.23(m)-1 to 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

* * * * *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and

the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.613-3. *Gross income from the property.*

* * * * *

(d) *Sales after the application of nonmining processes where a representative market or field price cannot be ascertained*—(1) *Computation of gross income from the property by use of the proportionate profits method.*

* * * * *

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall be properly apportioned to mining and to nonmining. In the absence of any specific provision of this section providing an apportionment method, such costs shall be apportioned by use of a method which is reasonable in the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other.

For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which would normally be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c) of § 1.613-4.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. The first marketable product or group of products does not include a product or group of products additionally refined, beneficiated, altered, or manufactured as a result of the application of additional nonmining processes. For example, if a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his

first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) As used in this paragraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations. The prices at which actual or constructive sales are made are to be determined in accordance with the principles set forth in this paragraph and in paragraphs (b), (c), and (e) of this section, as appropriate. In the case of constructive sales of the taxpayer's first marketable product or group of products, the taxpayer shall attach to his return a statement indicating the price or prices used by him in computing the representative market or field price for such product or products, and the source of his information as to such price or prices. The prices at which actual or constructive sales are made shall not be determined by reference to prices established in transactions between members of a controlled group. See paragraph (a) of § 1.482-1 for the definitions of the terms "controlled" and "group".

* * * * *

(4) *Treatment of particular items in computing gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facili-

ties, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer, and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which the district director determines will clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. Where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to such plants or mills in excess of 50 miles (or of such greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to such excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

* * * * *

(iii) In determining gross income from the property by use of the proportionate profits method (or any other approved method which is based on the taxpayer's costs)—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from the property by means of the proportionate profits method or any other approved method based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-4 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits atributable thereto are treated as nonmining profits.

* * * * *

(e) *Reductions of sales price in computing gross income from the property*— * * *

* * * * *

(2) *Purchased transportation to the customer.* * * *

* * * * *

(ii) In the case of a taxpayer computing gross income from mining under the provisions of paragraph (d) (1) of this section, the cost of purchased transportion to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the taxpayer's gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph) and from the denominator of the proportionate profits fraction, without attributing profits to the cost of such transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of methods of computation which are approved under paragraph (d) (2) of this section and which are based on the taxpayer's costs. For the treatment of costs and profits attributtable to transportation which does not meet the requirements of subdivision (iii) of this subparagraph, see paragraph (d) (4) (i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation from the taxpayer's mine or plant to the customer—

(a) Which is performed in conveyances owned or leased by persons other than the taxpayer, rather than in conveyances owned or leased by the taxpayer;

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the

customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling); and

(c) Which is charged to the customer in such a way that the taxpayer ordinarily does not earn any profit with respect to such transportation.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (a)(3) of § 1.482-1) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. The taxpayer must demonstrate the nonprofit character of the transportation services, as described in (c) of this subdivision, in light of all the facts and circumstances. It shall be presumed that the requirements set forth in either (a) or (c) of this subdivision (relating, respectively, to conveyance ownership and profits) are not satisfied if the taxpayer requires customers to purchase minerals or mineral products only on a delivered basis, by failing to offer such minerals or products for sale on the basis of a price f.o.b. the

taxpayer's mine or plant, or by other means. In the case of taxpayers computing gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms with the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(1)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

* * * * *

(g) *Nonmining processes*—* * *

* * * * *

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or

mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

* * * * *

§ 1.613-4 *Gross income from the property in the case of minerals other than oil and gas.*

* * * * *

(d) *Cases where a representative market or field price cannot be ascertained*—* * *

* * * * *

(3) *Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals

must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attribut-

able to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

* * * * *

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits

attributable thereto are treated as nonmining profits.

* * * * *

(4) *Proportionate profits method.* (i) The objective of the "proportionate profits method" of computation is to ascertain gross income from mining by applying the principle that each dollar of the total costs paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single taxpayer. See paragraph (j) of this section for the definitions of the terms "controlled" and "group."

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by

this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, section 39.23(m)-1 (e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining.}$$

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c)(4) of § 1.613-5.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing areas. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both

packaged and unpackaged, constitute his first marketable product or group of products.

(v) (a) As used in this subparagraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See (b) of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A "constructive sale" occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(b) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for

rules relating to information to be furnished by the taxpayer.

* * * * *

(e) *Reductions of sales price in computing gross income from mining*— * * *

* * * * *

(2) *Purchased transportation to the customer.** * *

* * * * *

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transporation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d) (3) (i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer—

(a) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer.

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling), and

(c) With respect to which the taxpayer ordinarily does not earn any profit.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (j)(1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transporta-

tion constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(4)(ix) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

* * * * *

(g) *Nonmining processes*—* * *

* * * * *

(3) *Transportation for the purpose of marketing or distribution; storage.* Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by

the operation of forces of nature, such as evaporation, drainage, or gravity flow.

(4) *Manufacturing, etc.* The production, packaging, distribution, and marketing of manufactured products, and the processes necessary or incidental thereto, are nonmining processes.

* * * * *

§ 1.613-5 *Taxable income from the property.*

* * * * *

(c) *Treatment of particular items in computing taxable income from the property.* * * *

* * * * *

(4) * * *

* * * * *

(ii) A reasonable portion of the expenses of selling a refined, manufactured or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

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IN THE

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OCTOBER TERM, 1980

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

PORTLAND CEMENT COMPANY OF UTAH,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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QUESTION PRESENTED

Whether for purposes of computing the percentage depletion allowance provided under Sections 611 and 613 of the Internal Revenue Code of 1954, an integrated miner-manufacturer of portland cement is entitled to apply the proportionate profits method consistently with the method's fundamental purpose of determining the market value of the crude mineral product, so that the market value will not be distorted either (1) by the inclusion in the formula of bagging services that are applied after the first marketable product is obtained and that do not earn a profit, or (2) by treating selling and other marketing expenses which benefit the entire integrated mining and manufacturing operation as relating solely to the manufacturing activity.

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BRIEF FOR THE RESPONDENT

STATUTES AND REGULATIONS INVOLVED

Sections 611 and 613 of the Internal Revenue Code of 1954 (26 U.S.C. §§ et seq.) and Treasury Regulations §§ 1.611-0, 1.613-4 and 1.613-5 (26 C.F.R. §§ et seq.), are set forth in the Appendix, *infra.*

STATEMENT OF THE CASE

A. *The Proportionate Profits Method*—Under the statutory framework of sections 611, 612 and 613 of the Internal Revenue Code of 1954,[1] the amount of the percentage depletion deduction is a statutory percentage of the market value of the taxpayer's mined mineral, referred to as its "gross income from mining," limited to

[1] All section references are to the Internal Revenue Code of 1954, as amended, 26 U.S.C., et. seq., unless specifically indicated otherwise.

50 percent of its net income from mining.[2] § 613; Reg. § 1.613-1.[3]

Pursuant to section 613(a), a miner's percentage depletion deduction is computed by applying the statutory percentage depletion rate of the mineral that it extracts to its "gross income from the property." Reg. § 1.613-1. With respect to mining, the term "gross income from the property" means income from the actual mining operation, which includes extraction of the ore or mineral from the ground and the application of allowable mining processes. § 613(c)(1)&(2); Reg. § 1.613-4(a).

In the case of minerals that are customarily sold in the form of a crude mineral product, such as coal or iron ore, the miner's gross income from mining—the market value of its mineral—is normally determined by looking to its actual gross receipts from the sales of its mineral products. Reg. § 1.613-4(b). There are other minerals, however, that because of their natural state are not sold in crude form, but are treated by nonmining processes after extraction to obtain a first marketable product. Typically, the miner of such minerals is an integrated miner-manufacturer. To compute the allowable depletion deduction in these cases the miner must determine a constructive gross income from mining—i.e., the market value of its mineral product at the point where, under section 613(c), mining ends and manufacturing begins (the "cutoff point").

When a mineral industry has both unintegrated miners and integrated miners also engaged in manufacturing, the integrated miner-manufacturer must determine the

---

[2] The miner is entitled to deduct a proportionate part of its cost basis in the mineral property allocated to the units of production of the mined mineral whenever the cost depletion allowance is greater than the percentage depletion allowance. § 612.

[3] All section references to regulations are to the Treasury Income Tax Regulations, 26 C.F.R., et. seq., unless specifically indicated otherwise.

market value of its mineral at the cutoff point on the basis of the representative market or field price charged by its unintegrated competitors who produce and sell a mineral product of like kind and grade in the same market. Reg. § 1.613-4(c). If there are no miners in a mineral industry who sell their mineral product without performing manufacturing processes, such as in the cement industry, or if a representative market or field price cannot be established for other reasons, the regulations generally require a miner to determine the market value of its mineral—its constructive "gross income from mining"—at the cutoff point under the so-called proportionate profits method:

> If it is impossible to determine a representative market or field price as described in paragraph (c) of this section then, except as provided in subdivision (ii) of this subparagraph, gross income from mining shall be computed by use of the proportionate profits method as set forth in subparagraph (4) of this paragraph. * * *. Reg. § 1.613-4(d)(1)(i).

The mechanics of the proportionate profits method are provided in Reg. § 1.613-4(d)(4)(ii). The method is generally applied by multiplying the miner's gross revenues (actual and constructive) from the sale of its first marketable product by a fraction, the numerator of which is the sum of all costs allocable to mining and the denominator of which is the total of all the mining and nonmining costs incurred to obtain such sales. This computation may be illustrated as follows:

$$\frac{\text{Mining costs}}{\text{Total costs}} \times \text{Gross sales} = \text{Gross income from mining}$$

Thus, the proportionate profits method operates on the premise that the same rate of profit is earned by each

dollar of cost incurred in the mining, manufacture, and sale of the first marketable product.

B. *The Facts of the Case*—Portland Cement Company of Utah (hereinafter PCCU) is an integrated miner-manufacturer of portland cement. It quarries argillaceous limestone rock,[4] known in the trade as cement rock,[5] and processes such rock into finished portland cement. (A. 33; T.C. Memo 1977-137 at p. 2).

Mining operations begin at PCCU's quarry near Salt Lake City. The cement rock is blasted free from the quarry face and pushed by bulldozers to the quarry floor. Secondary blasting, if necessary, reduces the size of large boulders. Jaw crushers and impactors reduce the size of the loose rocks to less than one square inch. The crushed material is then transported to PCCU's processing plant at Salt Lake City. (A. 34; T.C. Memo at p. 2).

At the cement plant, rod-ball mills grind the rock to a powder. Water is added to the powder to form a "slurry," a very fine mud. The slurry is then fed into rotary kilns. (A. 34; T.C. Memo at p. 3).

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[4] Referred to as "calcium carbonate" or "limestone" in Section 613(b)(7), Internal Revenue Code of 1954, subject to a 15 percent depletion rate for PCCU's fiscal year ended March 31, 1970, and a 14 percent depletion rate for fiscal years ended March 31, 1971, and March 31, 1972.

[5] PCCU's cement rock deposit is a rare type which is more valuable and more desirable than other types of limestone for use as a raw material in the manufacture of portland cement. PCCU's argillaceous limestone has the unique constituents of ideal chemical and physical proportion and combination for the manufacture of cement. *Portland Cement Co. of Utah* v. *United States*, unreported decision, Dkt. No. 12-60 (D. Utah 1966), unofficially reported at CCH 66-1 USTC ¶ 9430, at p. 86,026 and P-H 17 AFTR 2d 1028.

The mining phase of PCCU's operation concludes at this point—the "cutoff point." [6] (T.C. Memo at p. 3).

PCCU's manufacturing process begins when the liquid slurry is burned in the rotary kilns. The heat from the kiln expels moisture and converts carbonates into oxides. As the material is heated to an incipient fusion, chemical reactions inside the kiln produce complex silicates and aluminates. This sintering process produces a hard, glass-like "clinker." The clinker is cooled and later ground with purchased gypsum to produce finished portland cement. The finished cement is then placed in storage silos to await sales to customers. (A. 34-35, 67; T.C. Memo at p. 3-4).

PCCU sells most of its cement in bulk, loading it directly from the storage silos into tank trucks. It conveys a small portion of its bulk cement from the storage silo to a bagging machine where it is packaged in paper bags for sales to customers who purchase cement in bags.[7] (A. 67; T.C. Memo at p. 4).

During the taxable years in issue, PCCU incurred costs from its bagging operation and charged its customers a "bag premium" for the service of bagging the finished cement which produced losses attributable to the bagging operations, *per se*, as follows:

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[6] Section 613(c)(4)(F), Internal Revenue Code of 1954. The mining industry in general refers to the "cutoff point" as the point in an integrated mining-manufacturing operation at which allowable mining processes for tax purposes, i.e., the computation of percentage depletion, cease.

[7] During the taxable years in issue PCCU sold approximately 6 to 8 percent of its finished cement in bags. (A. 71). In prior years, PCCU's cement plant sold 6 to 10 percent of its finished cement in bags. (A. 72).

Fiscal Year Ended	Total Bags and Bagging Costs	Total Bag Premium Revenue	Net Loss From Bagging
March 31, 1970	$104,547.88	$49,137.00	$(55,410.88)
March 31, 1971	122,845.05	56,177.60	(66,667.45)
March 31, 1972	129,817.56	65,227.15	(64,590.41)

(A. 104-108).[8]

During the taxable years in issue, PCCU paid the following amounts of dues to the Portland Cement Association:

Fiscal Year Ended	P.C.A. Dues
March 31, 1970	$35,268.85
March 31, 1971	20,032.85
March 31, 1972	18,186.85

(A. 37-38).

PCCU also incurred selling expenses, attributable both to the compensation and business expenses of its salesman and to local advertising and promotion, in connection with the marketing of its finished portland cement as follows:

Fiscal Year Ended	Selling Expenses
March 31, 1970	$47,178.47
March 31, 1971	47,345.19
March 31, 1972	54,003.63

(A. 40).

PCCU incurred shipping and storage expenses in connection with the marketing of its finished portland cement as follows:

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[8] Although the Tax Court noted that the parties had stipulated the amounts of the expenses involved, it did not include such amounts in its Findings of Fact on the assumption that they "would not furnish an aid to an understanding of this case." See T.C. Memo at p. 4, ftnt. 3.

Fiscal Year Ended	Storing and Shipping Expenses
March 31, 1970	$ 95,594.28
March 31, 1971	113,538.53
March 31, 1972	118,953.56

(A. 39, 106-108).

The general overhead expenses, indirect expenses not identifiable with a particular mining or manufacturing activity, incurred by PCCU in connection with its mining-manufacturing operations conducted to produce portland cement were as follows:

Fiscal Year Ended	Overhead Expenses
March 31, 1970	$314,255.59
March 31, 1971	238,088.71
March 31, 1972	420,735.30

(A. 39).

PCCU arrives at the Court after approximately twenty years of litigation to resolve the matter of the proper depletion allowance that it is entitled to claim with respect to the cement rock mined at its quarry and manufactured into portland cement. Initially, PCCU contested its taxable years 1954 through 1956 in a protracted case that lasted 12 years and produced five separate decisions by the United States Court of Appeals for the Tenth Circuit.[9] While PCCU's case was pending, the Tenth Circuit

[9] In its first decision, the Tenth Circuit held, under existing law, that PCCU's first commercially marketable product was not finished cement. *United States* v. *Portland Cement Co. of Utah*, 293 F.2d 826 (10th Cir. 1961). In the second opinion involving the same years, the Tenth Circuit held that the depletion cutoff point (the first commercially marketable product) for PCCU was crushed limestone. 315 F.2d 169 (1963). In the third opinion involving the same years, the Tenth Circuit held that PCCU's mining ended with primary crushing, and that PCCU's gross income from mining must be determined at this point. 338 F.2d 798 (1964). In the fourth opinion involving the same years, the Tenth Circuit held, "on the record presented," that for percentage depletion purposes the proportionate profits method may be used to compute PCCU's constructive gross income from mining cement rock, and in doing so rejected PCCU's argument that a "substitute-materials" computation method

decided *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), in which it held that cement in bulk is an integrated miner-manufacturer's first marketable product under the proportionate profits method. Accordingly, in the fifth and final decision involving PCCU's taxable years 1954 through 1956, the court held that the government's application of the proportionate profits method with respect to PCCU was inconsistent with the proper application of the operative formula as set forth in *Ideal Basic*, and remanded the case to the trial court for disposition consistent with *Ideal Basic*. 412 F.2d 894 (1969).

PCCU followed the holding in *Ideal Basic* in the preparation of its income tax returns for fiscal years ended March 31, 1970 through March 31, 1972. Pursuant to *Ideal Basic*, PCCU took the position that finished cement in bulk was its first marketable product and that the bag premium and the bagging costs incurred in its bagging operation must therefore be excluded from the proportionate profits method computation. PCCU similarly excluded from the proportionate profits formula the costs that it incurred for the storage, distribution, and sale of its portland cement. (A. 17-31, 44-46, 50-52, 56-59, 63, 77).

On audit, the Commissioner of Internal Revenue determined deficiencies in PCCU's income tax liabilities for the fiscal years March 31, 1970 through March 31, 1972. The Commissioner's position is that:

(1) Finished cement, whether sold in bulk or in bags, constitutes PCCU's first marketable product, and

(2) The proportionate profits method employs a rigid mathematical formula which, when invoked, requires that the costs of all post-manufacturing functions—sales promotion, loading, storage, bagging and distribution—*always* be treated as nonmining costs and included in the "total costs" amount (the denominator of the fraction)

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more clearly reflected PCCU's gross income from mining. 378 F.2d 91 (1967).

used in the proportionate profits formula. (A. 12-16, 81-90, 91-99).

PCCU thereafter brought an action in the United States Tax Court for the redetermination of its deficiencies. The Tax Court upheld PCCU's computation of its constructive gross income from mining using the proportionate profits method. (Pet. App. 1a; T.C. Memorandum, 1977-137).[10]

On appeal by the government, the Tenth Circuit affirmed the holding of the Tax Court in a per curiam opinion, stating:

> As was held in our previous opinions, "bulk cement" is marketable as such, and under the Regulations it is the "first marketable product." The bagged cement is the next stage, and it is, as the Tax Court indicated, the second marketable product.
>
> The Government in its argument ignores the "first marketable" aspect of the Regulation, and would move to the second process—the bagging—because the cement in the bags is the same as in the bulk silos. It is obvious that both are "cement," but it is equally apparent that it is "first marketable" as bulk cement, not as bagged cement. (Pet. App. 12a, 14a-15a; 614 F.2d 724, 725 (10th Cir. 1979)).

The government then petitioned the Court for certiorari, which petition was granted on October 6, 1980. (A. 118).

SUMMARY OF ARGUMENT

I

A. The genesis of the present controversy is the percentage depletion allowance provided to miners. Section 611 of the Internal Revenue Code of 1954 provides a *reasonable* allowance for depletion, according to a miner's peculiar conditions. Under section 613(a) a miner must first determine its "gross income from mining"—the

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[10] Unofficially reported at CCH 36 TCM 578 and ¶ 77,136 P-H Memo TC.

market value of the crude mineral produced during the taxable year. Against this a statutory percentage, depending on the identity of the mineral product, is applied. The resulting amount (but not in excess of 50 percent of net income from mining) is the miner's percentage depletion allowance. Percentage depletion can be difficult to compute when there are no market values of the crude mineral product available because the miners in a particular mineral industry, such as the cement industry, manufacture their mineral product into a higher form. In this situation, a hypothetical market value must be ascertained; thus, the use of the proportionate profits method.

B. Regulation § 1.613-4(d)(4)(i) sets forth the proportionate profits method which operates by means of a formula comprised of a fraction, the numerator of which contains the costs of specified mining activities and the denominator of which in general contains all costs incurred with respect to activities occurring prior to the sale of the miner's first marketable product. The fraction is multiplied by the gross sales revenue of the first marketable product to produce an amount that is termed "gross income from mining"—the deemed market value of the miner's crude mineral product for purposes of computing percentage depletion. Reg. § 1.613-4(d)(4)(ii).

C. Mechanical application of this equation may be convenient, but it ignores the realities of the income produced by the various functions whose costs are utilized in the formula. It allows only considerations of relative costs to determine market value which, of course, is not the way the market really operates. More importantly, rigid application of the formula is inconsistent with the rationale of *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 83, 86, 88-89 (1960), that an integrated miner-manufacturer is to be treated as if it constructively sold its crude mineral product to itself for manufacture into the first marketable product.

D. The market value for PCCU's mineral product at the cutoff point will be distorted if there is included in the application of the formula, as the government would do, the post-manufacturing activity of bagging, a customer service performed after the first marketable product is obtained, which does not enhance the value of the first marketable product and the costs of which are exceeded by the bagging charge. It is clearly established in the record (A. 105) that in this case the bag premium revenues realized by PCCU on the sale of bagged cement were less than the costs of performing the bagging operation. In other words, not only did the bagging operation, *per se*, not earn a profit but it in fact operated at a loss.

E. Simply stated, this case concerns whether for purposes of computing the percentage depletion allowance of an integrated miner-manufacturer, the proportionate profits method, which employs a mechanical formula, should be rigidly applied, ignoring the actual facts of PCCU's bagging operation, to determine the gross income from mining—the hypothetical market value of the crude mineral product; *or*, whether the fundamental purpose of the formula—to determine that market value of the miner's crude mineral product—should take precedence so that the formula may be flexibly applied when actual facts are inconsistent with rigid application.

F. The Tenth Circuit in this case and in *Ideal Basic Industries, Inc.* v. *United States*, 404 F.2d 122 (10th Cir. 1968) correctly sought to avoid the impermissible distortion that results from mechanical application of the formula by determining that the first marketable product of a cement miner-manufacturer is cement in bulk and not bagged cement. The desired minimization of distortion is achieved either by this means or by finding implicit in the proportonate profits formula the flexibility to permit excluding the costs and associated revenues of the bagging activity, when such costs exceed such associated revenues.

H. The government has recognized that the inclusion in the proportionate profits method of costs on which a profit is not earned has a distortive effect. In Reg. § 1.613-4(d)(1)(iii) the costs of transporting the mineral product to customers, "purchased transportation," are excluded from the formula because ordinarily the miner does not earn a profit on these costs. This provision recognizes that adjustments can be made to the proportionate profits method to cure distortions without undermining the basic premise of the method. The government also has recognized the distortive effects of the proportionate profits method in Technical Advice Release 992 (Sept. 30, 1968), which holds that the proportionate profits method is never appropriate for determining the cutoff point market value in the case of oil and gas production.

G. PCCU does not seek to overturn the proportionate profits method. Instead, PCCU contends that the proportionate profits method must be applied with flexibility since the purpose of the method is to ascertain by constructive means the market value for the miner's crude mineral product that would have resulted if the miner had sold the mineral product rather than processing it into a manufactured product. Modification of the government's rigid application of the method does not require the use of an alternative method; merely, as the Tenth Circuit Court of Appeals has held, that a rule of reason should prevail. The flexibility of application urged by PCCU is limited, both in scope and substance. It is only available in a relatively small number of situations when actual facts concerning the bagging operation justify flexible application. Moreover, this application does not produce any administrative inconvenience beyond that which is already accepted by the government.

II

In like manner, if selling and other marketing costs that clearly benefit PCCU's entire mining-manufacturing operation are treated as allocable only to manufacturing

activities in the proportionate profits computation, this will improperly distort the value of PCCU's cement rock. Virtually all the courts that have addressed this issue have recognized that Reg. §§ 1.613-4 and 1.613-5 clearly permit selling costs to be allocated to mining as well as manufacturing, and have so allocated selling costs included in the proportionate profits formula. This has been done both because such costs benefited the entire integrated operation and because it was properly assumed that an unintegrated miner typically incurs selling costs. *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484, 486 (4th Cir. 1970); *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508-509 (9th Cir. 1970); *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 170-172 (9th Cir. 1969); *Whitehall Cement Manufacturing Co.* v. *United States*, 237 F. Supp. 838, 841 (E.D. Pa. 1965), *aff'd*, 369 F.2d 468 (3d Cir. 1966). A reasonable reading of the pertinent regulations likewise indicates that PCCU's marketing costs are properly allocable between its mining and manufacturing operations. Reg. §§ 1.613-4(d)(3)(iv), 1.613-5(c)(4).

ARGUMENT

I. THE INCLUSION OF THE BAGGING ACTIVITY IN THE PROPORTIONATE PROFITS FORMULA, WHEN BAGGING COSTS EXCEED THE BAG PREMIUM, PRODUCES AN IMPERMISSIBLY DISTORTED MARKET VALUE FOR THE CRUDE MINERAL PRODUCT.

A. The Purpose Of The Percentage Depletion Allowance Is To Compensate A Miner For The Exhaustion Of The Value Of Its Mineral, A Wasting Capital Asset.

The percentage depletion allowance is designed to compensate a taxpayer for the exhaustion of its mineral property as it is mined.[11] Under sections 611, 612, and

[11] The amount of the depletion allowance provided by section 611(a) must be reasonable, "according to the peculiar conditions of

613, the amount of the deduction is determined with reference to the taxpayer's "gross income from mining," which is the market value of the extracted mineral at the mining cutoff point.

In *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960), the Court held that the proper value of a miner's mineral product, which is the depletion base for purposes of the percentage depletion computation, "[should be] the competitive market receipts, or its equivalent received from the sale of the crude products, or concentrates on an f.o.b. mine, mill or well basis." 364 U.S. at 83. In reaching this conclusion, the Court emphasized that the percentage depletion computation has no relationship to extraction and processing costs:

> [Percentage depletion] is not a subsidy to manufacturers or the high-cost mine operator. The value of [the miner's products] obtained by expensive manufacturing processes, bears little relation to the value of its minerals. The question in depletion is what allowance is necessary to permit tax-free recovery of the capital value of the minerals. 364 U.S. at 86.

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each case." In all cases, the reasonableness of such allowance must be determined pursuant to regulations prescribed by the Treasury. See Reg. § 1.611-0.

Since the specific circumstances in each case must be taken into account in the determination of a reasonable depletion deduction, it is implicit that the computation of the depletion deduction will give effect to such circumstances, and will take into account the pertinent realities evident in a particular case. Consequently, whenever circumstances require the use of a formula method to compute a taxpayer's allowable depletion deduction, the application of such method must give effect to actual facts, so that it will result in a reasonable depletion allowance in that particular case. Thus, notwithstanding the authority in section 611 permitting the Treasury to implement the depletion allowance by regulations, such regulations still must permit reference to the facts and circumstances in each case in determining a taxpayer's reasonable depletion allowance. See, *United States* v. *Cartwright*, 411 U.S. 546, 550, 553-557 (1973), in which the Court held that a method of valuing mutual fund shares for federal estate tax purposes was invalid because it failed to reflect reality.

Consistent with this, *Cannelton* provided that recovery of the costs incurred in the mining and manufacturing operations has "nothing to do with the value in the [percentage] depletion formulae." 364 U.S. at 88. Rather, "[d]epletion, as we read the legislative history, was designed not to recompense for costs of recovery but for exhaustion of the mineral assets alone." 364 U.S. at 88. Thus, *Cannelton* held that the Congress intended to treat taxpayers engaged in integrated mining and manufacturing operations as if they constructively sold their mined mineral to themselves for manufacturing into a first marketable product. 364 U.S. at 89.

In other words, the teaching of *Cannelton* is that in the case of an integrated miner-manufacturer the two phases of the overall business must be separated into independent operations, so that the mining function is deemed to make constructive sales of the mineral product to the manufacturing function.

B. Literal Application Of The Proportionate Profits Method Produces A Distorted Value Of The Mineral At The Cutoff Point.

The proportionate profits method of determining the market value of the mineral at the cutoff point set forth in Reg. § 1.613-4(d), first appeared in 1940 in Reg. 103 (1939 Code), § 19.23(m)-1(f). During its 40-year existence, several courts have recognized the proportionate profits method as at least one reasonable means of determining a cutoff point market value in an appropriate case; i.e., when an integrated miner has no actual sales and is unable to refer to a representative market price to make such determination. E.g., *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484, (4th Cir. 1970); *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122, 125 (10th Cir. 1969); *Henderson Clay Products Co.* v. *United States*, 377 F.2d 349 (5th Cir. 1967).

The government's rigid application of the proportionate profits method, however, is at odds with the rationale of *Cannelton* because the proportionate profits method does

not treat the mining and manufacturing phases of an integrated miner as two separate businesses. Rather, rigidly applied, the proportionate profits method treats the entire mining-manufacturing operation as one business in the sense that profits derived from the sale of the first marketable product are arbitrarily allocated between the two functions. Pursuant to such allocation, neither business stands on its own and functions as an independent operation; nor is there any arm's-length market influence at work because each business must share its profits with the other.

Because the proportionate profits formula employs a mechanical cost allocation to determine the gross income from mining of the integrated miner-manufacturer—the market value of the mineral product at the cutoff point —it is apparent that the potential for distortion of that value increases with the addition of each post-mining process or function and the associated costs to the formula. In other words, the greater the number of non-mining processes, and accordingly the costs thereof included in the denominator of the formula, the greater the potential for unjustified variations in the market value attributed to the miner's mineral product at the cutoff point.

The distortive potential is particularly acute when there are included in applying the formula post-manufacturing functions, such as bagging, that do not produce incremental revenues sufficient to offset the costs attributable to such functions. This is because the proportionate profits formula assumes that such functions earn a proportionate amount of total revenue. When this happens, the reduction in the gross income from mining—the value of the mineral at the cutoff point—produced by the literal application of the proportionate profits method is distortive and unjustified.[12]

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[12] The only accounting authority cited by the government as purporting to support the proportionate profits method was written

Simply stated, this case presents the question whether, in applying the mechanical formula of the proportionate profits method to determine the hypothetical market value of the crude mineral product at the cutoff point, the application is to be a rigid one, ignoring actual facts, *or* whether there is to be sufficient flexibility in the application of the method to permit actual facts to be taken into account so that the purpose of the application—to determine the market value of the crude mineral product —can be achieved.

The Tenth Circuit in *Ideal Basic Industries, Inc.* v. *United States*, 404 F.2d 122 (10th Cir. 1968), recognized the necessity of doing something to eliminate the distortion which occurs when there is included in applying the formula the post-mining and manufacturing activity of bagging, the costs of which exceed the associated revenues. It sought to cure the distortion by determining that the first marketable product of an integrated miner-manufacturer of cement is cement in bulk and not also cement on which the additional activity of bagging has

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forty years ago, and when placed in proper context it is inapposite to the government's position. (G. Brf. p. 16). The cited authority neither describes the proportionate profits method nor discusses the application of such formula in any way. The subject of the discussion is income, not value; the allocation of profits is not mentioned. Moreover, the gist of the discussion is that all the costs of *a* particular business, not two businesses such as mining and manufacturing, must be treated equally for purposes of matching costs to revenue *to recover* such costs. Recouping all costs from gross revenue is quite different from the government's position that the market value of a mineral product at the cutoff point must be determined by allocating a proportionate amount of revenue, including profits, to each of the costs.

Even assuming *arguendo* that the proportionate profits method is based on generally accepted accounting principles, which it is not, the operative formula may not be rigidly applied when it does not clearly reflect PCCU's gross income from mining. *American Automobile Assn.* v. *United States*, 367 U.S. 687, 693 (1961); *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 538-539 (1979); see Reg. § 1.446-1(d)(3).

been performed. In other words, by this means the Tenth Circuit was simply recognizing that the proportionate profits formula must be applied by taking into account as few processes occurring after the cutoff point as is feasibly possible, if distortion in the determination of the value of the mineral product at that cutoff point is to be minimized.

The desired minimization of distortion is achieved by the means employed by the Tenth Circuit—treating cement in bulk as the first marketable product—or by finding implicit in the basic methodology of the proportionate profits formula the flexibility that can permit the exclusion from the formula of the costs and associated revenues of the bagging activity, the costs of which exceed the associated revenues.[13]

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[13] Neither the government's regulations concerning the depletion allowance, nor the government's application of the regulations is sacrosanct merely because of the delegation of authority to the Treasury in section 611. Several courts, although upholding parts of Reg. § 1.613-4 or its predecessors in general, have not accepted the government's application of the rules in these regulations. In *Barton Mines Corp.* v. *Commissioner*, 446 F.2d 981, 994 (1971), *rev'g in part*, 53 T.C. 241, 258 (1969), both the Second Circuit and the Tax Court refused to follow the government's restrictive "sudden death" rule that all processes following the first nonmining process must be treated as nonmining processes for purposes of computing percentage depletion. In *Ranchers Expl. and Dev. Corp.* v. *United States*, —— F.2d —— (10th Cir. 1980) (unofficially reported at CCH 80-2 USTC ¶ 9815 at p. 85,692; P-H 46 AFTR2d 80-6124 at p. 80-6129), the court used a "common sense" analysis in holding that two sophisticated processes—solvent extraction and electrowinning—were not refining, a nonmining process under Reg. § 1.613-4(g)(6)(iii), but mining processes "within the spirit" as well as "the letter of the law permitting depletion." In *Union Carbide Corp.*, 75 T.C. No. 16 (November 12, 1980) (unofficially reported at CCH Dec. 37,391 at p. 4405 and ¶ 75.16 P-H TC at p. 75-136), the court reached the same conclusions as both *Barton Mines* on the "sudden death" rule in Reg. § 1.613-4(g)(2) and *Rancher's Expl. and Dev.* on solvent extraction.

PCCU *does not* contest the validity of a proportionate profits technique for determining the market value of its mineral product—its constructive gross income from mining. PCCU's position is simply that because the proportionate profits method employs a mechanical formula to determine a market value, which formula relies entirely on costs for the allocation of revenue, it is susceptible to distortion of constructive gross income from mining if it takes into account nonmining processes or functions that occur beyond the point at which constructive gross income from mining can first be determined. Accordingly, it must not be literally and blindly applied. Rather, its application must be carefully restricted so that the potential for distortion through the introduction of additional nonmining operations, the prices charged for such operations, and the costs incurred in such operations does not undermine the overriding purpose of Reg. § 1.613-4. That is to say, the constructive gross income from mining determined under the proportionate profits method should represent as nearly as feasible the market value of the miner's crude mineral product.[14]

That market value will be distorted, however, if there are included in the application of the formula, as the government would do, the costs and revenues relating

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[14] PCCU's flexible application of the proportionate profits method is a refinement to the method, not an alternative method as contemplated in the procedure set forth at Reg. § 1.613-4(d)(1)(ii). The central premise of the proportionate profits method—that all operating costs earn a proportionate share of sales revenue—is still the operative force. Its application is essentially retained intact, since all direct and indirect mining and manufacturing costs, by far the majority of the costs, are utilized. Solely costs that are attributed to the discrete post-manufacturing function of bagging are excludable, and only when actual facts demonstrate that the function, per se, did not earn a profit.

Consistent with this, the government's own regulations set forth alternative methods that are based on entirely different theories. None of these theories utilizes operating costs as a basis of valuing the mineral product. Reg. §§ 1.613-4(d)(5)-(7).

to the post-manufacturing activity of bagging, a customer service which is subsequent to and does not enhance the value of the first marketable product, and does not otherwise produce a profit on its own. In other words, the proportionate profits method should be applied with a degree of flexibility in a case such as this, since the purpose of the method is to ascertain by constructive means the market value for the miner's crude mineral product that would have resulted if the miner had sold the mineral product rather than processing it into a manufactured product.

On the other hand, the government's position is that once invoked the proportionate profits formula must always be rigidly and literally applied, regardless of whether the result produced—the value of the taxpayer's mineral at the cutoff point—is a reasonable one in light of the actual facts.[15] This position exalts the form in which the proportionate profits method operates over the substantive value which the method seeks constructively to obtain.

C. In The Cement Industry, Bagging Is Associated With A Clearly Identifiable Income Item—The Bag Premium.

When customers purchase portland cement from PCCU in bags, rather than in bulk, they pay an additional charge for a given quantity of cement. The excess of the price of bagged cement over the price for the same quantity of bulk cement is referred to as a "bag premium." The bag premium is uniformly paid by all

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[15] The government implies that the proportionate profits method likewise is based on sales data. (G. Brf. p. 2). That implication is misleading because the sales data is attributable to a product that is substantially different from the crude mineral product being valued. For this reason, the proportionate profits method should be readily susceptible to compensating adjustments to minimize the distortions in the "workback" mechanism of the proportionate profits formula to obtain a value for the pre-existing mineral products.

customers who buy bagged cement. Thus, sales of bagged cement have a specifically identifiable income item that can be segregated from the sales revenues attributable to bulk cement. This fact is clearly established on the Tax Court record. (A. 104-108).

A comparison of PCCU's total bagging costs with its total bag premium revenue during each of taxable years in issue establishes that such costs exceeded the total bag premium revenues by significant amounts:

Fiscal year ended	Excess bagging costs
March 31, 1970	$55,410.88
March 31, 1971	66,667.45
March 31, 1972	64,590.41

(A. 100-103).

The obvious result is that PCCU's bagging service, *per se*, did not produce a profit, but actually was operated at a loss for each of the taxable years involved.

Since the government takes the position that portland cement is the first marketable product in the manufacture of cement, there should be no dispute that bagging is a post-manufacturing activity with marketing objectives.[16] Bagging is also a discrete function that is performed on bulk cement after it leaves the manufacturing area of

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[16] Logically, bagging costs are essentially selling costs which, because they benefit PCCU's entire integrated operation, should be allocated between mining and manufacturing. The regulations appear to take a contrary position. Reg. § 1.613-4(d)(3)(iii). Since selling costs, including bagging costs, do not enhance the inherent value of either the cement rock or finished cement, the inclusion of such costs at all in a mechanical allocation formula is open to serious question. This is especially the case since percentage depletion is not intended to be related to costs or cost recovery. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 88 (1960). To the extent, however, that selling costs, including bagging costs, are included in the formula, they must be considered to benefit equally the mining and manufacturing phases of the operation and, accordingly, must be ratably allocated to both phases.

the cement plant. Moreover, bagging is a discretionary service that is only done in response to a specific request by a customer; it is a customer accommodation. Whether cement is bagged is dependent on a particular customer's order.

There is no storage of bagged cement since bagging occurs at the time that a customer places an order to purchase cement in bags. In this sense, the bagging operation is an incidental part of the overall operation of PCCU's cement plant. Consistent with this, bagged cement accounts for only a small part—6 to 8 percent—of PCCU's total cement sales.

Based on the undisputed evidence in the record that the costs of PCCU's bagging service exceeded the bag preminum revenues, it is clear that bagging costs did not produce a profit, and there is no logical reason why the application of the proportionate profits method should require the inclusion of bagging costs in the computation, with the effect that they are presumed to earn a profit. Inclusion of the bagging costs in the computation unjustifiably distorts the market value of the mineral product (kiln-feed) produced by the mining operation.

This distortion is particularly onerous in this case since the facts show that PCCU mines a unique type of cement rock which has a high value as a raw material for use in the manufacture of portland cement. PCCU's cement rock is valuable because it contains the major constituents needed to manufacture cement. This reduces both mining and manufacturing costs.

PCCU's mining operations are cost-efficient because PCCU is not required to duplicate its mining operations to obtain both calcium and silica, the two primary ingredients necessary to manufacture finished cement; a single mine produces both. Post-extraction mining processes also are simplified because there is less blending of purchased additives to obtain the desirable kiln-feed mixture.

D. Rigid Application Of The Proportionate Profits Method Produces Anomalous Results.

The present case—one in which the bagging service does not result in a profit—is a perfect example of the unjustified distortion in the market value of the mineral product that can result from a rigid application of the proportionate profits method. Under the government's mechanical interpretation of the formula, two equal units of identical kiln-feed—the mineral product at the cut-off point—manufactured into finished cement and sold on the same date in the same market area will have different values depending on whether the finished cement is sold in bulk or in bags. In other words, if kiln-feed is processed into finished cement that is sold both in bulk and in bags the kiln-feed in the bags will, when subjected to a mechanical application of the proportionate profits method, be determined to have a lower value per unit at the cutoff point than the value of kiln-feed sold in the form of bulk finished cement.

This unjustified distortion is also illustrated by the case of two integrated miner-manufacturers in the same market who have identical mineral deposits and mining and manufacturing operations, and who incur identical operating costs. The only distinction between the two businesses is that one sells most of its finished cement in bulk and the other sells most of its finished cement in bags and, as in PCCU's case, does not make a profit on the bagging operation. A mechanical application of the proportionate profits method will result in the identical cement rock at the cutoff point—kiln-feed—having a lower market value for the integrated miner that sells most of its cement in bags, than for the rival integrated miner that sells most of its finished cement in bulk.

Such discrimination in result makes no sense. The value of the mineral product is being altered because of an operation, which itself does not result in a profit, that follows both mining and manufacturing. In effect,

the method of disposition has an unjustified impact on the value of an integrated miner's mineral product although both the mineral product and the first marketable product are the same as the products of its competitor.

Rigid application of the proportionate profits method says the miner's cement rock at the cutoff point has one market value when it is sold to the bulk cement manufacturer and a lower market value when it is sold to the bag cement manufacturer. This is a patently unrealistic result. An unintegrated cement rock miner would not sell its mineral product for one price when the purchaser is a manufacturer of bulk cement and at a lower price when the purchaser is a manufacturer of bagged cement. Stated differently, the cement rock miner would not lower the price of its mineral product to the manufacturer of bagged cement just because the manufacture and sale of cement in bags is less profitable than the manufacture and sale of bulk cement.

E. The Proportionate Profits Formula Should And Does Have Room For Recognizing Reality.

The regulations demonstrate that excluding nonprofitable costs from the proportionate profits formula does not abuse the fundamental premise of such formula. This is clearly seen in the treatment of "purchased transportation" in Reg. § 1.613-4(e)(2)(ii). Under these provisions, an adjustment is made in the application of the proportionate profits method so that no profit is attributed to the cost of purchased transportation for delivery to either the customer or temporary storage.[17] The cost of that transportation is excluded from the miner's gross sales figure of the first marketable product and from the

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[17] Apparently, similar treatment is allowed for sales taxes which are passed on to the customer. (A. 77). It is clear in the case of taxes, as in the case of purchased transportation, that the miner does not earn a profit on that cost.

denominator of the proportionate profits fraction because it is clear that the miner does not earn a profit on this transportation. This treatment is contrary in principle to the application of the proportionate profits method contended for by the government.

The provisions of Reg. § 1.613-4(e)(2)(ii), regarding the treatment of purchased transportation, establish that neither administrative convenience nor the central premise of the proportionate profits method are unduly jeopardized when actual facts are taken into account to make reasonable compensating adjustments to the application of such method.[18]

Another clear illustration of the government's recognition that the proportionate profits method distorts is the government's blanket refusal to apply such method to determine the constructive value of the oil and gas produced by an integrated producer. In Technical Information Release 992 (September 30, 1968)[19] the government stated that the proportionate profits method of computation is not appropriate in the case of producers of petroleum and natural gas. It said that use of the proportionate profits method is inappropriate in cases in which the costs paid to produce, sell and transport the first marketable product from oil and gas production are not substantial compared to the taxpayer's gross sales of such product, and that pertinent data indicated that the costs associated with oil and gas pro-

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[18] Making adjustments in the application of the proportionate profits method to reflect reality is consistent with the flexibility indicated in Reg. §§ 1.613-4(c) & (e) concerning the application of the representative market or field price method. In determining representative prices there is leeway in determining market size, Reg. § 1.613-4(c)(3); comparability of mineral products, Reg. § 1.613-4(c)(4); nonrepresentative sale transactions and sale price adjustments, Reg. § 1.613-4(e)(1) & (2). See *Bloomington Limestone Corp.* v. *United States*, 445 F.2d 1105 (7th Cir. 1971) and *Hugoton Prod. Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965).

[19] Unofficially published at CCH 687 SFTR ¶ 6929E, P-H ——.

duction only average about 17.5 percent of the gross sales receipts of the marketed product. See *Hugoton Production Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965).

F. By Determining That Cement In Bulk Is The First Marketable Product And Accordingly Requiring That All Post-Manufacturing Functions Be Excluded From The Proportionate Profits Formula, The Court Of Appeals Sought To Achieve An Application Of The Proportionate Profits Method Which Avoids Distortion And Provides A Representative Value Of The Taxpayer's Mineral Product.

The post-manufacturing operations of an integrated miner-manufacturer are services performed for the benefit of customers. As a consequence, including post-manufacturing costs and their related income in the proportionate profits formula distorts the imputed value of the mineral product.

The Tenth Circuit has consistently recognized the distortive effect of including nonprofit costs in the proportionate profits formula. In an opinion concerning PCCU's case for taxable years 1954 through 1956, *United States* v. *Portland Cement Co. of Utah*, 378 F.2d 91 (10th Cir. 1967), *cert. denied*, 389 U.S. 975 (1968), the court reasoned that, "[i]f inclusion of unproductive costs so distorts the equation that the application of the formula does not in fact clearly reflect the gross income from the property, they may be excluded." 378 F.2d at 94-95. Based on the record in that case, however, the court refused to exclude any post-manufacturing costs from the proportionate profits formula because it determined that PCCU had not made an adequate showing that specific costs were unproductive.

Subsequently, in *United States* v. *Ideal Basic Industries, Inc.*, 404 F.2d 122, 127 (10th Cir. 1968), both the majority and the dissenting opinions recognized that there is a distortion of the miner's depletion base when

the proportionate profits formula is applied without any reference to the income produced by the costs utilized.

In *Ideal Basic*, the court was concerned about the distortive effect of including post-manufacturing costs in the proportionate profits formula:

> [t]he basic principle concerned is to allow a deduction to compensate for the depleting resource and, therefore, the [proportionate profits] formula is oriented to the value of the resource at the time of its extraction rather than to the ultimate sale price of the manufactured product. 404 F.2d at 126.

Noting that the value sought by use of the proportionate profits formula is the real price at which kiln-feed would sell in a hypothetically free market place, the court concluded that:

> The intent [of the proportionate profits formula] is to establish this real market price as near the mine as possible, therefore, the liturgy of "first marketable product." * * * * The logic of this approach is, the closer to the mine that the mining costs, the cost of the bulk cement, and the free market price can be established, the smaller the possibility of the distortion of the depletion figure, and the fairer the result for the taxpayer and the government. 404 F.2d at 126-127.

To minimize the potential distortion, the Tenth Circuit determined that the first marketable product of a cement manufacturer is bulk cement. By this determination, the costs of subsequent operations, such as bagging, selling, transportation and terminal expenses, were excluded from the application of the proportionate profits method. These post-manufacturing costs thus could not result in distortions in the determination of the value of the kiln-feed —the mineral product at the cut-off point.

By concluding that bulk cement was the first marketable product of an integrated cement miner-manufacturer,

the court remedied the distortive effect of including post-manufacturing activities in the formula in a forthright and practical manner. The Tenth Circuit correctly found sufficient flexibility in the language of the regulation to allow application of the proportionate profits method so that the inherent distortions of the method were minimized.[20]

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[20] In general, pro rata allocation of any item is arbitrary because it assumes uniformity when reality rarely assumes a constant pattern. Although convenient in application, pro rata allocations are subject to the criticisms of inaccuracy and artificiality. Indeed, the Court criticized and rejected as unacceptable a pro rata allocation of income in another tax context because it was artificial and did not clearly reflect income. See *American Automobile Assn.* v. *United States*, 367 U.S. 687, 693 (1961).

The Courts have consistently recognized that the proportionate profits method is subject to distortion when nonprofit costs are improperly taken into account, even though under the specific facts of the situations involved, they did not find a basis for corrective action. *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508 (9th Cir. 1970); *General Portland Cement Co.* v. *United States*, 438 F. Supp. 27, 32 (N.D. Tex. 1977), *aff'd on this issue*, 628 F.2d 321 (5th Cir. 1980); *Whitehall Cement Manufacturing Co.* v. *United States*, 242 F. Supp. 327, 329 (E.D. Pa. 1965), *aff'd* 369 F.2d 468 (3d Cir. 1966).

The Court of Claims also has recognized the tendency of the costs and revenues associated with post-manufacturing functions to distort a proper application of the proportionate profits formula. In *Hugoton Production Co.* v. *United States*, 349 F.2d 418 (Ct. Cl. 1965), the court resorted to a modified representative market or field price method to determine the wellhead value of the taxpayer's unprocessed natural gas because, due to the lack of any meaningful relationship between the costs of producing natural gas and the costs of processing such gas prior to sale, the proportionate profits formula produced a gross income from the mineral property which was not a representative value in light of market realities.

North Carolina Granite Corp. v. *Commissioner*, 56 T.C. 1281 (1971), *acq. in result*, 1974-2 C.B. 3, provides a classic example of the potential distortive effect of a rigid application of the proportionate profits method. In that case the taxpayer operated a stone quarry in concert with two manufacturing operations—a curb stone division and an ornamental stone division. The orna-

G. The Argument Advanced In *Whitehall Cement Manufacturing* And In *General Portland Cement* And Relied Upon By The Government That Some Of The Value Created By A Miner's Mining-Manufacturing Operation Is Properly Allocable To Bagging Is Erroneous.

In *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468 (3d Cir. 1966), the court recognized that the bag premium the taxpayer charged its customers was less than the costs of the bagging service. Notwithstanding such fact, the court adopted a literal application of the proportionate profits method. It accepted the trial judge's erroneous reasoning[21] that a pro rata share of the taxpayer's profits from the mining and manufacture of finished cement was allocable to the bagging service because the taxpayer realized a profit on the sale of bagged cement, albeit less than on the sale of bulk cement, and because:

> It seems reasonable to infer that the profits realized from the sale of packaged cement, and these were substantial, were attributable at least in part to packaging costs. 369 F.2d at 474.

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mental stone division was a inefficient operation, and its products were sold at a loss. The court found that every dollar of cost in the taxpayer's operations did not produce the same amount of profit, 56 T.C. at 1290, and then gave effect to that finding in its application of the proportionate profits formula. The court concluded that since the purpose of any method of computing gross income from mining is to arrive at a figure which approximates the result that would obtain if actual market prices were available for the taxpayer's mineral product, it was appropriate to modify the application of the proportionate profits method formula to exclude the costs and the income attributable to the ornamental stone division. 56 T.C. at 1291. The holding in *North Carolina Granite Corp.* demonstrates that a reasonable, comon sense application of the proportionate profits method based on actual facts is not only permissible under the regulations but also appropriate.

[21] 242 F.Supp. 326, 329 (E.D. Pa. 1965).

Subsequently, this rationale was also advanced by the Fifth Circuit in *General Portland*, 628 F.2d 321 (1980).

The rationale in *Whitehall Cement* is erroneous for several reasons. Principally, the rationale ignores the reason for which the proportionate profits method is applied, and it is contradicted by the clear results of implementing that rationale. The purpose for which the proportionate profits method is applied is to determine the market value of the taxpayer's mineral product at the cutoff point. It is not merely to engage in some theoretical profit allocation. As previously demonstrated, the inclusion of demonstrably nonprofit post-manufacturing costs, such as the costs of the bagging operation in the present case, in the application of the proportionate profits method, will produce an absurd result. (See pp. 23-24, *supra*). The value at the cutoff point of the taxpayer's cement rock that is ultimately sold as finished cement in bags will be lower than the value at the cutoff point of the identical cement rock which is ultimately sold as finished cement in bulk.

There is no disputing that the taxpayers in *Whitehall Cement* and *General Portland Cement* realized profits from the sale of bagged cement, and realized profits from the sale of cement in bulk. To that extent, the statements in these cases that the taxpayers' profits are partly attributable to the sale of bagged cement are correct. It is fallacious reasoning, however, to proceed from that factual conclusion to a legal conclusion which results in different values for the taxpayer's cement rock at the cutoff point, depending on whether the rock is processed into cement that is sold in bulk or into cement that is sold in bags. That is precisely the result of relying on the *Whitehall* rationale to justify the inclusion of nonprofit, post-manufacturing costs, such as those of a bagging operation, in the application of the proportionate profits method. Moreover, it bears emphasis that the purpose of the proportionate profits formula is not

to ensure the recovery of bagging costs, but to determine a representative value of PCCU's cement rock at the cutoff point. This is the teaching of *Cannelton*. 364 U.S. at 88. (See pp. 14-15, *supra*).

Although the bagging costs in these cases did not create a loss on cement sold in bags, the bagging costs were not entirely recovered from the bag premium charged for the bagging service. Viewing the bagging service as a discrete function from mining and manufacturing, the bagging operation, *per se*, was not profitable. In light of the distortive effect of such bagging costs on the proportionate profits method, this finding alone is an adequate basis for excluding them from such formula.

The speculation in *Whitehall Cement* [22] that the bagging service may engender goodwill as a customer accommodation and, thus, presumably generate additional income from the sale of finished cement is also not a persuasive argument. Every service that a business performs to satisfy a customer may engender goodwill. However, goodwill is not income, much less profit. It is an intangible attribute, the value of which is uncertain at best in this context. In fact, there is no certainty that the bagging service even creates goodwill. It is a traditional service that is expected in the cement industry. Virtually every cement plant offers such service. The bagging operation is an incidental activity to the general objective of producing portland cement.

The government does not seek to include purchased transportation costs in the proportionate profits method formula based on intangible goodwill benefits. Reg. § 1.613-4(e)(2). However, such service also presumably creates goodwill by relieving the customer from the burden of having to arrange for such transportation and, perhaps, by providing such transportation at a lower cost due to volume usage. The significant point is that

[22] 242 F.Supp. 326, 329 (E.D. Pa. 1965).

although the bagging function, similarly to purchased transportation, may increase the amount of sales of finished cement, neither service, following the actual mining and manufacturing operations, enhances the inherent value of finished cement or earns a profit on its own.

In short, the considerations of whether or not the taxpayer makes a profit on the bagging of cement or whether the sale of bagged cement at a premium that is less than the costs of bagging creates goodwill or is an accommodation to the consumers relate to fundamentally different questions than the one addressed by the proportionate profits method. The question the proportionate profits method seeks to answer, and the purpose for which it is being applied, is to determine the value of the taxpayer's mineral product at the cutoff point—the statutory point at which an unintegrated cement rock miner would sell its mineral product to an unrelated manufacturer of finished cement.

II. PCCU'S SELLING AND OTHER MARKETING COSTS BENEFIT THE ENTIRE MINING AND MANUFACTURING OPERATION AND ARE PROPERLY ALLOCATED BETWEEN ITS MINING AND ITS MANUFACTURING OPERATIONS BASED ON THE PROPORTIONATE RELATIONSHIP OF DIRECT COSTS.

A. Marketing Costs Are Indirect Costs That Are Inextricably Linked To Both Mining And Manufacturing.

PCCU incurs selling and other marketing expenses.[23] These relate to expenses consisting primarily of the compensation, together with entertainment and automobile expenses, that it pays its salesman, who is responsible for selling finished cement to industrial and commercial users, and to storing and shipping expenses. A minor amount of selling expenses is attributable to local advertising and public relations.

During each of the years in issue PCCU also paid substantial dues to the Portland Cement Association.[24] A substantial portion of these dues were used by the Portland Cement Association to promote the use of portland cement. The parties have agreed that the Portland Cement Association dues constitute indirect costs which should be apportioned between mining and nonmining

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[23] The amounts involved are as follows:

	Selling Expenses	Storing and Shipping Expenses
March 31, 1970	$47,178.47	$ 95,594.28
March 31, 1971	47,345.19	113,538.53
March 31, 1972	54,003.63	118,953.56

(A. 39-40, 106-108).

[24] The amounts involved were as follows:

March 31, 1970	$35,268.85
March 31, 1971	20,032.84
March 31, 1972	18,186.85

(A. 37-38).

based on the proportion of the direct costs of mining to the direct costs of nonmining. (A. 38).

Any product whether mined or manufactured must be marketed to make a profit. Without the sales of the finished cement, PCCU would be unable to operate either its mining or its manufacturing functions. Presumably, some sales and promotion activities are conducted in most businesses. Consequently, marketing costs are in the nature of indirect costs which benefit the entire integrated operation, both the mining and the manufacturing phases.

B. Under The Circumstances Involved, The Government May Not Narrowly Apply Reg. § 1.613-4(d)(3)(iv) So As To Compel PCCU To Provide Direct Proof That Unintegrated Miners In The Cement Industry Typically Incur Selling Costs.

Regulation § 1.613-4(d)(3)(iv) provides that in computing gross income from mining under the proportionate profits method, selling expenses and trade association dues may be treated as indirect costs attributable to mining to the extent allowable under the principles set forth in Reg. § 1.613-5(c)(5). Indirect costs may be allocated between mining and manufacturing based on the proportion of direct mining costs to total direct nonmining costs. Reg. § 1.613-4(d)(4)(iii).[25]

Regulation § 1.613-5(c)(4) pertains to the treatment of selling expenses for purposes of computing a miner's taxable income from the mineral property:

> A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treat-

[25] Under the court of appeals' holding that cement in bulk is the first makretable product, these costs are excluded from the proportionate profits formula and, thus, the question of allocation is not reached; in this case allocation produces the same result.

> ment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property. Reg. § 1.613-5(c) (4) (ii).
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> * * * *
>
> "[S]elling expenses" [in this regard] includes [such items as] sales management salaries, rent of sales offices, sales clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and similar expenses, together with an allocable share of the costs of supporting services. § 1.613-5(c) (4) (iv).

Although in the case of the cement industry there is no intrinsic difference between marketing expenses in the form of selling expenses and marketing expenses in the form of loading, storage and distribution expenses, Reg. § 1.613-4(d) (3) appears to differentiate between these two categories of marketing expenses. The resulting difference in treatment is wholly without justification.[26]

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[26] Although Reg. § 1.613-4(d) (3) (iii) provides that the costs of bulk loading of, and operation of warehouses or distribution terminals for, manufactured products are nonmining costs for purposes of the proportionate profits method, it is clear that loading, storage and distribution costs incurred during the marketing phase equally benefit the mining and manufacturing phases of PCCU's entire integrated operation. Moreover, the government recognizes that loading, storage and distribution are not significant "processes" since purchased transportation to or from "incidental storage" may be excluded from the proportionate profits formula. Reg. § 1.613-4(e) (2) (iii) (b). Accordingly, to the extent Reg. § 1.613-4(d) (3) (iii) is considered applicable with respect to the cement industry, it is invalid. Since the storage and distribution expenses in question benefit PCCU's entire operation, they must be allocated for purposes of the proportionate profits method to both phases of the entire operation in the same manner as is provided in Reg. § 1.613-4(d) (3) (iv) for selling expenses.

The government's position with respect to PCCU's selling expenses and its other marketing expenses is a predictable extension of the rigid position that it has taken with respect to bagging costs. On brief, the government contends that PCCU is not entitled to allocate its selling expenses between its mining and manufacturing operations because it made no such showing that unintegrated miners in the cement industry would incur such selling expenses. (G. Brf. p. 25). The government concedes that several courts have taken a contrary position in this regard, but seeks to create the impression of being consistent with such cases by arguing that they were decided under earlier regulations that did not require a taxpayer to prove that unintegrated miners typically incur selling costs. (G. Brf. pp. 25-26).

The government's narrow reading of the provisions in the regulations concerning the treatment of selling expenses produces a harsh result which is necessary and unjustified.

As previously indicated, the cement industry is a fully integrated industry; it has no unintegrated miners. This is because the mineral product—cement rock—has no market of its own.[27] For this reason PCCU cannot directly prove that unintegrated miners of cement rock, who presumably would process such material into kiln-feed for use in the manufacture of portland cement, would typically incur selling expenses. By the same token, however, the allocation of selling expenses between mining and manufacturing results in equality of treatment among all cement rock miners since they all have integrated operations. Thus, the purpose of Reg. § 1.613-5 (c) (4) (ii) is fulfilled.

If there were unintegrated miners in the cement industry they would incur sales expenses to market their

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[27] *United States* v. *Portland Cement Co. of Utah*, 293 F.2d 826, 828 (10th Cir. 1961).

product to industrial cement manufacturers. Similarly, they would incur loading, storage and distribution expenses. Whether or not there *actually* are unintegrated cement miners, the *Cannelton* rationale presumes that there are. It is obvious that such a hypothetical, unintegrated cement rock miner would incur the same type of selling, storage, loading and distribution expenses as are incurred by PCCU.

Moreover, the government's position with respect to PCCU's local selling and marketing expenses is inconsistent with its treatment of Portland Cement Association dues. Recognition of this is implied in Reg. § 1.613-4(d)(3)(iv), which treats trade association dues and selling expenses essentially the same. The benefits that PCCU derives from the promotional activities are indistinguishable from the benefits derived from the sales activity of PCCU's salesman and its local advertising and promotional activities.

The cases that have considered the proper treatment of selling costs under the proportionate profits method formula have held that such selling costs are indirect costs which benefit the entire mining-manufacturing operation, and that such costs may be allocated between mining and manufacturing based on the direct costs attributable to such operations. In *Whitehall Cement Manufacturing Co.* v. *United States*, 237 F. Supp. 838 (E.D. Pa. 1965), *aff'd*, 369 F.2d 468 (3d Cir. 1966), the trial court specifically recognized that the government did not contend that the taxpayer's selling expenses were unusual in the cement industry or that such expenses would not have been incurred by an unintegrated miner. The court also noted that general administrative expenses benefited the entire mining-manufacturing operation and should be allocated between the two operations in proportion to the direct costs. Thus, there was no apparent reason why the two types of expenses—selling expenses and general administrative expenses—

should be accorded different treatment. 237 F. Supp. at 841.

The Ninth Circuit has also considered the proper treatment of selling expenses in the proportionate profits formula when applied to the cement industry. On two separate occasions, the court held that the taxpayer was entitled to allocate selling expenses between mining and manufacturing based on the direct costs incurred in each such operation. *Southwestern Portland Cement Co.* v. *United States*, 435 F.2d 504, 508-509 (9th Cir. 1970); *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 170-172 (9th Cir. 1969).

What the government seeks with its narrow reading of Reg. § 1-613-5(c)(4) is to reverse the traditional presumption that miners normally incur selling expenses. Such narrow construction, however, must fail.

In *California Portland Cement* the Ninth Circuit properly assumed that mining businesses normally incur selling expenses, and it cited substantial authority, including *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960), in support of this assumption. Concluding its analysis, the court commented that if an expense is incurred for the benefit of the entire operation, it can properly be allocated between mining and manufacturing:

> Otherwise, the nonintegrated miner would receive a tax advantage not intended by Congress. 413 F.2d at 172.

Asked to reconsider its position on the allocation of selling costs a year later, the Ninth Circuit again reached the same result in *Southwestern Portland Cement Co.*, 435 F.2d at 508-509.

Similarly, in *Arvonia-Buckingham Slate Co.* v. *United States*, 426 F.2d 484 (4th Cir. 1970), the court reasoned that the costs of advertising and sales are not directly identifiable with either a particular mining process or

a particular nonmining process. It concluded that such costs should be apportioned in accordance with the direct costs that are associated with the mining and manufacturing phases. Beyond this, the court held that the lower court's determination that all advertising and selling expense should be allocated to the nonmining phase was clearly erroneous in both fact and law. 426 F.2d at 486-487.

In summary, selling expenses and other marketing expenses, such as loading, storage and distribution, are in the nature of indirect costs which benefit the entire integrated mining and manufacturing operation. Such expenses are permissible mining costs, and should be allocated between mining and manufacturing based on the direct costs incurred in each such function. To reach this result requires only a reasonable reading of the regulations. It is not necessary to declare either Reg. § 1.613-4(d) (3) (iv) and Reg. § 1.613-5(c) (4) invalid.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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APPENDIX

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by Secretary. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * * *

SEC. 613. PERCENTAGE DEPLETION.

(a) GENERAL RULE.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding

sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as ordinary income, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

* * * *

(c) DEFINITION OF GROSS INCOME FROM PROPERTY.—For purposes of this section.

(1) GROSS INCOME FROM THE PROPERTY.—The term "gross income from the property" means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

(2) MINING.—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

* * * *

(4) TREATMENT PROCESSES CONSIDERED AS MINING.—The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

* * * *

(F) in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating of the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

* * * *

Treasury Regulations on Income Tax (1954 Code):

* * * *

§ 1.611-0. Regulatory authority.—Sections 1.611-1 through 1.614-8, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 611(a) of the Code to prescribe regulations under which a reasonable allowance for depletion and depreciation of improvements shall be allowed, according to the peculiar conditions in each case, in the case of mines, oil and gas wells, other natural deposits and timber.

* * * *

§ 1.611-1. Allowance of deduction for depletion.—(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allow-

ance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

* * * *

§ 1.613-4. Gross income from the property in the case of minerals other than oil and gas.—(a) *In general.* * * *

* * * The term "gross income from the property," as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. "Gross income from mining" is that amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. * * *

* * * Processes, including packaging and transportation, which do not qualify as mining will be referred to as "nonmining processes." Also for the purpose of this section, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "nonmining transportation."

* * * *

(b) *Sales prior to the application of nonmining processes including nonmining transportation.* (1) Subject to the adjustments required by paragraph

(e)(1) of this section, gross income from mining means (except as provided in subparagraph (2) of this paragraph) the actual amount for which the ore or mineral is sold if the taxpayer sells the ore or mineral—

(i) As it emerges from the mine, prior to the application of any process other than a mining process or any transportation, or

(ii) After application of only mining processes, including mining transportation, and before any nonmining transportation.

* * * *

(c) *Cases where a representative market or field price for the taxpayer's ore or mineral can be ascertained*—(1) *General rule.* If the taxpayer processes the ore or mineral before sale by the application of nonmining processes (including nonmining transportation), or uses it in his operations, gross income from mining shall be computed by use of the representative market or field price of an ore or mineral of like kind and grade as the taxpayer's ore or mineral after the application of the mining processes actually applied (if any), including mining transportation (if any), and before any nonmining transportation, subject to any adjustments required by paragraph (e)(1) of this section. See paragraph (e)(2)(i) of this section for certain other situations in which this paragraph shall apply. The objective in computing gross income from mining by the representative market or field price method is to ascertain, on the basis of an analysis of actual competitive sales by the taxpayer or others, the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if, prior to the application of nonmining

processes, the taxpayer had sold the quantities and types of ores and minerals to which he applied non-mining processes. If it is possible to determine a market or field price under the provisions of this paragraph, and if that price is determined to be representative, the taxpayer's gross income from mining shall be determined on the basis of that price and not under the provisions of paragraph (d) of this section. The taxpayer's own actual sales prices for ores or minerals of like kind and grade shall be taken into account when establishing market or field prices, provided that those sales are determined to be representative.

* * * *

(d) *Cases where a representative market or field price cannot be ascertained*—(1) *General rule.* (i) If it is impossible to determine a representative market or field price as described in paragraph (c) of this section then, except as provided in subdivision (ii) of this subparagraph, gross income from mining shall be computed by use of the proportionate profits method as set forth in subparagraph (4) of this paragraph. A method of computing gross income from mining under the provisions of this paragraph shall not be deemed to be a method of accounting for purposes of paragraph (e) of § 1.446-1.

(ii) (*a*) The Office of the Assistant Commissioner (Technical) may determine that a method of computation is more appropriate than the proportionate profits method or the method being used by the taxpayer. The taxpayer may request such a determination (see (*d*) of this subdivision (ii)). If the taxpayer is using a method of computation which has been determined by the Office of Assistant Commissioner (Technical) to be more appropriate than the proportionate profits method, such method

shall continue to be used until it is determined by the Office of Assistant Commissioner (Technical) that either the proportionate profits method or another method is more appropriate.

(*b*) The proportionate profits method is more appropriate than the method being used under (*a*) if, under the particular facts and circumstances, the method being used under (*a*) consistently fails to clearly reflect gross income from mining and the proportionate profits method more clearly reflects gross income from mining for the taxable year.

(*c*) An alternative method (a method other than the method being used under (*a*) (if any) and the proportionate profits method) is more appropriate than the method being used under (*a*) (if any) and the proportionate profits method if, under the particular facts and circumstances, the latter methods consistently fail to clearly reflect gross income from mining, and the alternative method being considered more clearly reflects gross income from mining on a consistent basis than the method being used under (*a*) (if any) and the proportionate profits method. When determining whether a method of computation clearly reflects gross income from mining, it is relevant to compare the gross income from mining produced by such method with the gross income from mining, on an equivalent amount of production, which results from the computation methods used by competitors. When determining the acceptability of proposed alternative methods, primary consideration will be given to computation methods based upon representative charges for ores, minerals, products, or services. See paragraph (c) of this section for principles determining the representative character of a charge.

(*d*) Application for permission to compute gross income from mining by use of an alternative method shall be made by submitting a request to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, D.C. 20224.

(*e*) Among the alternative methods of computation to which consideration will be given, provided that the requirements of this subdivision (ii) are met, are the methods listed in subparagraphs (5), (6), and (7) of this paragraph. The order in which these methods are listed is not significant, and the listing of these methods does not preclude a request to make use of a method which is not listed.

(iii) Approval and continued use of any method of computation under this paragraph depends upon all the facts and circumstances in each case, and shall be subject to such terms and conditions as may be necessary in the opinion of the Commissioner to reflect clearly the gross income from mining. Accordingly, the use of such a method for any taxable year shall be subject to review and change.

(2) *Costs to be used in computing gross income from mining by use of methods based on the taxpayer's costs.* In determining the taxpayer's gross income from mining by use of methods based on the taxpayer's costs, only costs actually paid or incurred shall be taken into consideration. In general, if the taxpayer has consistently employed a reasonable method of determining the costs of the various individual phases of his mining and nonmining processes (such as extraction, loading for shipment, calcining, packaging, etc.), such method shall not be disturbed. The amount of any particular item to be taken into account shall, for taxable years beginning after No-

vember 30, 1968, be the amount used in determining the taxpayer's income for tax purposes. For example, the depreciation lives, methods, and records used for tax purposes, if different from those used for book purposes, shall be the basis for determining the amount of depreciation to be used. However, a taxpayer may continue to use a reasonable method for determining those costs on the basis of the amounts computed for cost control or similar financial or accounting books and records if that method has been used consistently and is applied to the determination of all those costs.

(3) *Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.* (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over

the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

(ii) In determining gross income from mining by use of methods based on the taxpayer's costs, a process shall not be considered as a mining process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nonmining costs in determining gross income from mining. If a mining process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining gross income from mining. Accordingly, all profits attributable thereto are treated as nonmining profits. In the absence of other methods which clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, that cost shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs—

(*a*) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(*b*) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(*c*) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

(v) See paragraph (e) (1) of this section for provisions excluding certain allowances from the taxpayer's gross sales and costs of his first marketable product or group of products.

(4) *Proportionate profits method.* (i) The objective of the "proportionate profits method" of computation is to ascertain gross income from mining by applying the principle that each dollar of the total cost paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single tax-

payer. See paragraph (j) of this section for the definitions of the terms "controlled" and "group."

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, § 39.23(m)-1(e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

$$\frac{\text{Mining Costs}}{\text{Total Costs}} \times \text{Gross Sales} = \text{Gross Income from Mining}$$

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on

the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c) (4) of § 1.613-5.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayers or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an inte-

grated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) (*a*) As used in this subparagraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See (*b*) of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A "constructive sale" occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(*b*) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive

sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for rules relating to information to be furnished by the taxpayer.

* * * *

(5) *Representative schedule method.* The "representative schedule method" is a pricing formula which uses representative finished product prices, penalties, charges and adjustments, established in arms-length transactions between unrelated parties, to determine the market or field price for a crude mineral product. The representative character of a price, penalty, charge, or adjustment shall be determined by applying the principles set forth in paragraph (c) of this section. The representative schedule method is principally intended for use in those industries in which such a schedule-type pricing method is in general use to determine the price paid to unintegrated mineral producers for their crude mineral product. For example, if unintegrated producers of copper concentrate in a particular field or market customarily sell their product at prices which are determined in accordance with a schedule-type pricing formula, consideration will be given to the determination of concentrate prices for integrated copper producers in accordance with the same pricing formula. The representative schedule method shall not be used if it is impossible to determine one or more of the elements in the representative schedule formula by reference to prices, penalties, charges, or adjustments established in representative transactions between unrelated parties. See paragraph (c) of this section for principles determining the representative character of a charge.

(6) *Method using prices outside the taxpayer's market.* Under the "other market method" the taxpayer uses representative market or field prices established outside his markets, provided that conditions there are substantially the same as in his markets. For example, it may be appropriate in a particular case to establish the representative market or field price for pellets containing 60 percent iron which are produced and used in market area X by reference to the representative market or field price for pellets containing 60 percent iron which are produced and sold in adjacent market area Y, provided that conditions in the two marketing areas are shown to be substantially the same.

(7) *Rate of return on investment method.* [Reserved]

(e) *Reductions of sales price in computing gross income from mining*—(1) *Discounts.* If a taxpayer computes gross income from mining under the provisions of paragraph (b) (1) of this section, trade discounts and, for taxable years beginning after November 30, 1968, cash discounts actually allowed by the taxpayer shall be subtracted from the sale price of the taxpayer's ore or mineral. If a taxpayer computes gross income from mining under the provisions of paragraph (c) of this section, any such discounts actually allowed (if not otherwise taken into account) by the person or persons making the sales on the basis of which the representative market or field price for the taxpayer's ore or mineral is to be determined shall be subtracted from the sale price in computing such representative market or field price. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, such discounts actually allowed (if not otherwise taken into account) shall be subtracted

from the gross sales (actual or constructive), and shall not be considered a cost, of the first marketable product or group of products. The provisions of this subparagraph shall apply to arrangements which have the same effect as trade or cash discounts, regardless of the form of the arrangements.

(2) *Purchased transportation to the customer.* (i) A taxpayer who computes gross income from mining under the provisions of paragraph (c) of this section and who sells his ore or mineral after the application of only mining processes but after nonmining transportation shall use as the representative market or field price his delivered price (if otherwise representative) reduced by costs paid or incurred by him for purchased transportation to the customer as defined in subdivision (iii) of this subparagraph. If the transportation by the taxpayer is not purchased transportation to the customer, or if the taxpayer does not sell the ore or mineral until after the application of nonmining processes and if other producers in the taxpayer's marketing area sell significant quantities of an ore or mineral of like kind and grade after the application of only mining processes but after purchased transportation to the customer, the representative delivered price at which the ore or mineral is sold by those other producers reduced by representative costs of purchased transportation to the customer paid or incurred by those producers shall be used by the taxpayer as the representative market or field price for his ore or mineral in applying paragraph (c) of this section. Furthermore, appropriate adjustments shall be made to take into account differences in mode of transportation and distance. When applying this subdivision, the representative market or field price so computed shall not exceed the taxpayer's delivered price less his actual costs of transpor-

tation to the customer. For purposes of this subdivision, any delivered price shall be adjusted as provided in subparagraph (1) of this paragraph.

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d) (3) (i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer—

(*a*) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer,

(*b*) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling), and

(*c*) With respect to which the taxpayer ordinarily does not earn any profit.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (*j*) (1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b) (1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transportation constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d) (4) (iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

* * * *

§ 1.613-5 *Taxable income from the property.*

* * * *

(c) *Treatment of particular items in computing taxable income from the property.* In determining taxable income from the property under the provisions of paragraph (a) of this section—

* * * *

(4) (i) Selling expenses, if any, paid or incurred with respect to a raw mineral product shall be subtracted from gross income from the property. See subdivision (iii) of this subparagraph for the definition of the term "raw mineral product." For example, the selling expenses paid or incurred by a producer of raw mineral products with respect to products such as crude oil, raw gas, coal, iron ore, or crushed dolomite shall be subtracted from gross income from the property.

(ii) A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

(iii) For purposes of this subparagraph, a product will be considered to be a raw mineral product if (in the case of oil and gas) it is sold in the immediate vicinity of the well or if (in the case of minerals other than oil and gas) it is sold under the conditions described in paragraph (b) (1) of § 1.613-4. In addition, a product will be considered to be a raw mineral product if only insubstantial value is added to the product by nonmining processes (or, in the case of oil and gas, by conversion or transportation processes). For example, in the case of a producer of crushed granite poultry grit, both bulk and bagged grit will be deemed to be a raw mineral product for purposes of the selling expense rule set forth in this subparagraph.

(iv) The term "selling expenses", for purposes of this subparagraph, includes sales management salaries, rent of sales offices, sales clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and similar expenses, together with an allocable share of the costs of supporting services, but the term does not include delivery expenses.

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No. 79-1907

In the Supreme Court of the United States

OCTOBER TERM, 1980

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PORTLAND CEMENT COMPANY OF UTAH

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. Although respondent disclaims (Br. 12) that it seeks to overturn the proportionate profits method and contends that its claimed exclusion of bagging premium income and bagging costs is simply a "modification" of the proportionate profits formula to take account of "actual facts" (Br. 17), it is plain that its argument is tantamount to an assault on the validity of the method itself.

It is undisputed that an integrated miner-manufacturer such as respondent is treated as selling the material it mines to itself. Since respondent's deple-

tion base is its constructive gross income from the *mining* phase of its operation, the income from other, post-mining processes must be eliminated from its depletion base. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 86, 89 (1960); *Riddell* v. *Monolith Cement Co.*, 371 U.S. 537, 538-539 (1963). Here, respondent acknowledges (Br. 36) that there is no representative market price for the raw material upon which it claims a depletion allowance. As a result, the pertinent Treasury Regulations (Section 1.613-4(d)(1) and (4) (26 C.F.R.), Br. App. 19a-23a),[1] required respondent to compute its gross income from mining under the proportionate profits method unless it could demonstrate a more appropriate method.

As we have more fully set forth in our opening brief (at 14-17), the proportionate profits method extrapolates the integrated miner-manufacturer's gross income from mining by multiplying the gross sales of its first marketable product by the fraction of its mining costs over its total costs. The central premise of the method is that every dollar of total costs paid or incurred to produce, to sell and to transport the first marketable product earns the same percentage of the sales proceeds. Treasury Regulations, Section 1.613-4(d)(4)(i) and (ii). For an integrated miner-manufacturer of cement, Section 1.613-4(d)(4)(iv) of the Regulations provides that cement is its first marketable product. In accordance with the underlying assumption of the proportionate profits method, Sections 1.613-4(d)(3)(iii) and 1.613-4(d)(4)(iv) of the Regulations provide that the gross sales of cement, including that sold in bags, and the

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[1] "Br. App." refers to the appendix to our opening brief, which sets forth the statutes and regulations involved.

costs of bags and bagging incurred in selling cement were to be included in the proportionate profits equation. The exclusion of any part of gross sales or the costs incurred to produce gross sales will distort the underlying method, with the result that the depletion allowance will not be restricted to its intended ambit, *i.e.*, to compensate the miner for the exhaustion of his mineral assets.

a. Respondent, however, argues (Br. 10-12, 15-32) that because the premium it charged for bagged cement did not cover the bagging costs, the bagging premium and the bagging costs should be excluded from the formula. In respondent's view, the failure to exclude the bagging premium and bagging costs distorts the true market value of its raw material and results in a less favorable depletion allowance than is available to those who sell cement only in bulk.

But respondent's argument rests upon the erroneous assumptions that bulk cement and bagged cement are two different products, and that bagging costs produced only the additional revenue derived from the bagging premium. Respondent's cement is indisputably the same product, whether sold in bulk or in bags (J.A. 40). Moreover, the stipulated fact is that respondent "realized a net profit on the sale of each bag of cement" (J.A. 103). It is plain that respondent undertook to pack cement in bags in response to a particular customer demand for bagged cement. These customers would not have purchased the cement if respondent had not packed it in bags. Hence, for these customers, bagged cement is respondent's first marketable product. As we stated in our opening brief (at 21, 29), it is therefore reasonable to infer that the bagging costs contributed to respondent's

profits.[2] Accordingly, both the bagging premium and

[2] Apart from the decision below, the courts have uniformly concluded that bagging costs did not simply produce an equivalent amount of bagging premium income. Rather, the courts have held that bagging costs produced profits in the sale of cement and that such profits were not properly a part of gross income from mining. Hence, the inclusion of such costs as nonmining costs in the proportionate profits method will eliminate the profits from the depletion base attributable to bagging costs. See *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468, 474 (3d Cir. 1966); *United States* v. *California Portland Cement Co.*, 413 F.2d 161, 169 (9th Cir. 1969); *General Portland Cement Co.* v. *United States*, 628 F.2d 321, 330-333 (5th Cir. 1980); and *Standard Lime and Cement Co.* v. *United States*, 329 F.2d 939, 949 (Ct. Cl. 1964). Respondent concedes (Br. 29-30) that in these cases, the bagging costs either were the same as the bagging premiums or, as in the instant case, exceeded the bagging premiums. Yet in each case, as here, the taxpayer made a net profit on the sale of each bag of cement.

The amicus curiae relies (Br. 12-14) on a number of cases (*e.g.*, *United Salt Corp.* v. *Commissioner*, 40 T.C. 359 (1963), aff'd, 339 F.2d 215 (5th Cir. 1964); *Standard Realization Co.* v. *United States*, 289 F.2d 247 (7th Cir. 1961)), which stand for the proposition that the costs of bags and bagging are nonmining costs in determining the cutoff point at which mining ceased. But those cases are distinguishable. As the Fifth Circuit in *General Portland Cement Co.* v. *United States*, *supra*, 628 F.2d at 332-333, and the Ninth Circuit in *United States* v. *California Portland Cement Co.*, *supra*, 413 F.2d at 169, correctly pointed out, those cases did not involve the application of the proportionate profits method to integrated producers. Rather, they involved determinations of the "commercially marketable * * * product" of the mining processes of nonintegrated miners in accordance with the representative price method. Most of these decisions took into account this Court's decision in *Cannelton* that a raw mineral is a commercially marketable product when it is suitable for industrial use and consumption, and can be shipped for such use, whether or not it can be sold at a profit. In *Riddell* v. *Monolith Ce-*

the bagging costs must be included in the proportionate profits equation in gross sales and total costs, respectively.

Indeed, there is no difference in function between the costs of loading a railroad car and the costs of loading a bag. The loading of the cement into a railroad car or bag, is not, as the amicus would have it (Br. 3, 11-12), further processing. Processing, as the amicus concedes (Br. 11), is an operation that alters the physical or chemical characteristics of the product. Bagging, on the other hand, is simply an operation designed to put the cement into the hands of the customer in the desired manner, *i.e.*, making available the first marketable product. Respondent does not argue for exclusion of the costs of loading its bulk cement into a railroad car. Bagging cement

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ment Co., 371 U.S. 537 (1963), this Court held that limestone has reached this state when it is crushed. In such a case, bagging of the limestone would not be a mining process because the "commercially marketable" product was simply the crude mineral resulting from mining processes, which were then defined by statute as "the ordinary treatment processes normally applied by mine owners or operators". Accordingly, those cases properly hold that bagging the crude mineral was a post-mining operation, and the costs of bagging could not be reflected in the taxpayer's depletion base. There is no representative market price for kiln feed, the cut-off point product, and, therefore, the proportionate profits method must be used. The first marketable product is cement, made ready for the customer in the form he desires, either in bulk or in bags. Under the proportionate profits method, no cost of producing and selling cement can be excluded from the formula.

The amicus disputes (Br. 20) our inference that respondent sold the bagged cement in response to customer demand. But neither it nor respondent offers any other reason for respondent's bagging expenditures. Indeed, the silence of the record that the amicus cites (*ibid.*) does not support respondent's claims since it bore the burden of proof in this Tax Court proceeding.

is a comparable operation for a significant quantity of respondent's sales. Surely both costs were necessary to sell its first marketable product, viz., cement. Hence, both costs must be included as non-mining costs in the proportionate profits formula.

Moreover, respondent's argument that the proportionate profits method as applied distorts the true market value of its mined material overlooks the fact that Congress has tied the percentage depletion allowance to *income* actually or constructively received from mining operations, without regard to the value of the mineral. Section 613(a) and (c) of the Code (26 U.S.C.). See also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956). Indeed, the proportionate profits method is required to be employed in the instant case precisely because there is no evidence from which respondent's gross income from mining could be computed.[3]

b. Second, there is no evidence to support respondent's uncorroborated assertion (Br. 23-24) that it received a less favorable depletion allowance than those who sell cement in bulk, or that the application of the proportionate profits method as set forth in the Treasury Regulations distorts its depletion allowance.[4] Section 611 of the Code authorizes the deduc-

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[3] Respondent's reliance (Br. 18 n.13) upon the decisions involving the so-called "sudden death" rules that all processes following the first nonmining process must be treated as nonmining processes is misplaced. Unlike the instant case, where respondent seeks to invalidate Regulations which explicitly provide that bulk *and* bagged cement is the first marketable product, those cases involved competing interpretations of Regulations that are not at issue in this case.

[4] Respondent also argues (Br. 4, 7, 22) that the proportionate profits method distorts its gross income from mining because it mines a unique type of cement rock which has a

tion of a reasonable allowance for depletion "according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate." Under this congressional authorization, the Commissioner of Internal Revenue chose the proportionate profits method to compute gross income from mining for depletable hard minerals in the absence of a representative market price or in the absence of a more appropriate method. As we pointed out in our opening brief (at 8, 19-20), this Court has held that the legislative Regulations adopted by the Commissioner in the multifarious circumstances involving questions of depletion are entitled to special deference. "In this area of limitless factual variations, 'it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.' " *Bingler* v. *Johnson*, 394 U.S. 741, 751 (1969), quoting from *United States* v. *Correll*, 389 U.S. 299, 307 (1967). The Commissioner has reasonably determined by Regulation that cement, whether in bulk or in bags, is the first marketable product, and that bagging premiums and bagging costs must be included in the proportionate profits equation.[5]

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high value as a raw material for use in the manufacture of portland cement and because its mining operations are cost-efficient. There is no factual basis to support either argument. But even on the assumption that respondent mined a valuable limestone material used in the manufacture of portland cement from 1954-1956, these assertions have no relevance as to whether its bagging premium and the bagging costs should be included in the proportionate profits method for 1970-1972.

[5] The amicus argues (Br. 24 and App. B-1 to B-3) that the application of the proportionate profits method as set forth in the Regulation attributes part of the bulk sales to bagged

To be sure, the proportionate profits method is an approximation of gross income from mining. But the absence of a market price for the mineral in question necessarily requires that some method of approximation be used in determining constructive income. The Commissioner's proportionate profits method represents a reasonable implementation of the statutory authorization. Under this method, the taxpayer's gross income from mining depends upon its mining and nonmining costs incurred in making its gross sales of cement. Of course, these costs will vary from taxpayer to taxpayer. And it might well be that a taxpayer selling cement only in bulk would have less gross income from mining than a taxpayer selling cement in bulk and in bags or only in bags. At all

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sales. But if the costs of bags were excluded from the equation, the profit that they generate in selling cement would be attributable to bulk sales. Because those costs indisputably contribute to respondent's profit from the sale of cement, they must be included in the proportionate profits equation. All the amicus' argument proves is that there are various ways in which the Commissioner might have constructed the proportionate profits method. As an approximation, the proportionate profits method is not perfect. But since Congress gave the Commissioner the power to determine the reasonable allowance for the depletion deduction by Regulation, the Commissioner's choice must be approved as long as it is reasonable. The fact that the amicus has suggested an alternative computation—involving two fractions rather than a single fraction—that produces a greater depletion allowance and that might also be deemed reasonable, is an insufficient basis upon which to invalidate the Commissioner's method. "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *United States* v. *Correll, supra,* 389 U.S. at 307.

events, respondent cannot claim that the Regulations treat it unfairly, since all similarly situated integrated miner-manufacturers are treated exactly the same.[6] The Regulations permitted respondent to come forward with another method to construct its gross income from mining. But it chose to rely upon the proportionate profits method. Once having done so, respondent may not engage in selective implementation of the proportionate profits formula in a manner designed to increase its depletion allowance. The mathematical integrity of the formula demands that it take into account all gross sales and costs incurred in producing the first marketable product. Hence, bagging premium income and bagging costs must be included in respondent's gross income and nonmining costs.[7]

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[6] There is no basis for the amicus' argument (Br. 23) that the Regulations treat respondent less favorably than a taxpayer under the representative price method. Such a comparison is not valid. The essential point is that the proportionate profits method must be employed only because there is no representative price for the mined ore that would justify use of the representative price method. Thus, all similarly-situated taxpayers throughout the integrated cement industry are subject to the application of the proportionate profits method.

[7] Respondent contends (Br. 12, 25-26) that the proportionate profits method as set forth in the Regulations may be modified by the courts because the Commissioner has determined that such method is inapplicable in constructing the gross income from mining in the case of oil and gas. But the oil and gas industry demonstrated to the Commissioner that other methods were more appropriate to construct the gross income from the property than the proportionate profits method. Unlike the cement industry, the costs incurred in the oil and gas industry to produce, sell, and transport the first marketable product are not substantial compared with the product's gross sales. See IRS Technical Information Release 992 (Sept. 30, 1968). Respondent, as well as the integrated

2. Respondent further argues (Br. 10, 14-16, 21) that the Commissioner's application of the proportionate profits method in this case is contrary to this Court's decision in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960). In *Cannelton*, the Court determined the cut-off point for mining under the pre-1960 statute. In making this determination, the Court indicated that an integrated miner-manufacturer is entitled to depletion only on his constructive income from the raw mineral product of "mining." The Court did not address the question presented here as to how an integrated miner-manufacturer's constructive income from mining should be computed under the proportionate profits method. Thus, in *Cannelton*, the Court did not hold that the percentage depletion base could not be computed under a cost-ratio method such as the proportionate profits formula. It simply ruled that the representative market price had to be used in that case even though it had no relationship to taxpayer's mining costs and failed to provide taxpayer with a profit.

For more than 40 years, the Regulations have prescribed the proportionate profits method for computing the gross income from mining of integrated miner-manufacturers. That method is wholly in accord with the statute and with *Cannelton*. Under the statute, the depletion allowance is a percentage of gross income from mining. *Cannelton* limits an inte-

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cement industry as a whole, had the same opportunity to make a similar demonstration. But they have not done so. At all events, the fact that the proportionate profits method is not employed in constructing the gross income from oil and gas extraction does not support respondent's argument that the proportionate profits method should be modified with respect to the bagging premiums and bagging costs of integrated producers of cement.

grated producer to depletion on his constructive income from constructive sales of the mining product to himself. Under the proportionate profits method, this constructive income is derived from actual figures—the taxpayer's gross income from sales of its manufactured product (cement) and its costs of producing and selling that product.

3. Contrary to respondent's further argument (Br. 12, 24-25), the bagging costs in this case are not analogous to the costs of purchased transportation to the customer, which Section 1.613-4(e)(2) of the Regulations permits to be excluded from the proportionable profits formula. See Br. App. 12a-15a. That Regulation deals only with nonmining transportation of a taxpayer's finished products to the customer where: (1) the transportation is made in conveyances owned by a party other than the taxpayer, (2) the transportation is solely a function of delivery of the purchased products to the customer rather than a function of transporting the taxpayer's minerals or unfinished cement for packing or other additional processing by the taxpayer (other than incidental storage or handling), and (3) the taxpayer can show that these costs do not ordinarily earn any profit.

Purchased transportation to the customer represents a cost which may be viewed as producing a profit, not to the cement miner-manufacturer, but rather to the transporter. Section 1.613-4(e)(2)(iii) of the Regulations specifically contemplates an arm's-length charge ordinarily paid by shippers of the product in similar circumstances. The Regulation permitting exclusion of the costs of purchased transportation to the customer represents an administrative determination that such costs, incurred under

the narrowly circumscribed requirements of the Regulation, do not produce a profit to the taxpayer. Here, on the other hand, bagging costs, incurred by respondent to make sales to customers who will buy only bagged cement, did in fact produce a profit to respondent (J.A. 103). Hence, bagging costs are not comparable to transportation costs paid to a third-party.

Indeed, the more appropriate analogy would be to Treasury Regulations, Sections 1.613-4(d)(3)(i) and 1.613-4(g)(3), Br. App. 16a-18a, 25a-26a, which deal with transportation costs other than purchased transportation of the finished product to the customer, such as transportation of ore to processing plants, or to marketing or distribution centers. Such costs are regarded as producing a profit to the miner-manufacturer. Hence, as in the case of bagging costs, these transportation costs are classified as either mining or nonmining within the context of the proportionate profits formula.

4. With respect to the second question presented, respondent apparently agrees with the Commissioner that the court below erred in excluding from the proportionate profits equation the costs of storing, shipping and selling and, if gross sales of cement sold in bags are included, the costs of bags and bagging. But respondent claims (Br. 12-13, 33-39) that these costs benefit the entire mining-manufacturing operation and should be allocated between mining and manufacturing operations in the costs fraction of the proportionate profits formula rather than included in the denominator as non-mining costs.

Apart from the fact that there is no factual foundation for respondent's assertion that such costs benefitted its entire operation, the argument is fore-

closed by Section 613(c)(4)(F) and the controlling Treasury Regulations (Section 1.613-4(d)(3)(i), (iii) and (iv), 1.613-4(g)(3) and (4), and 1.613-5 (c)(4)(ii) (see our opening brief, at 24, n.10, and Br. App. 5a, 16a-19a, 25a-26a)). Section 613(c)(4)(F) provides that in the case of minerals used in making cement, mining includes all processes up to kiln feed "but not * * * any subsequent processes." Subsequent manufacturing and marketing processes incurred after kiln feed are classified as nonmining costs. The function of Section 613(c)(4) was, as the sponsor of the provision stated, "to preclude the interpretation of the term [mining] as including operations involved in processing the finished product, the packaging, and the shipping of the finished product" (106 Cong. Rec. 13240 (1960)). Thus, in *Standard Lime and Cement Co.* v. *United States*, *supra*, 329 F.2d at 946-947, the Court of Claims correctly stated:

> We believe that Congress intended to include in gross income from mining only those cost items (and a percentage of the entire profit attributable to them) which were incurred for the benefit of the mining operations as defined in section 613(c)(4). This result is inescapable since we must view depletion as "an allowance for the exhaustion of a capital asset." United States v. Cannelton Sewer Pipe Co., supra, 364 U.S. at 86, * * *. This capital asset under the statutory definition is measured for depletion purposes in terms of "gross income from mining." It follows that only those costs incurred for the benefit of the mining operation as particularized by the statutory scheme, can be included. The language of subparagraph (F) of subsection 613(c)(4) demands this conclusion,

> for it specifically includes all processes up to kiln feed "but not including *any subsequent processes*. [Emphasis in original.] We interpret this as excluding any subsequent manufacturing or marketing processes. * * * [W]e must view the miner-manufacturer as selling to itself the processed minerals at the kiln feed stage. United States v. Cannelton Sewer Pipe Co., supra, 364 U.S. at 87 * * *. Thus taxpayer, the miner, does not incur those subsequent costs which its alter ego (the manufacturer and distributor) must incur to sell the end product. To view this in any other perspective would introduce the tax discrimination between integrated and non-integrated miners against which the whole tenor of the Cannelton decision was directed.

Accord: *General Portland Cement Co.* v. *United States, supra*, 628 F.2d at 333-335; *Whitehall Cement Manufacturing Co.* v. *United States*, 369 F.2d 468, 473 (3d Cir. 1966); *United States* v. *California Portland Cement Co., supra*, 413 F.2d at 169.

In a general sense, all of an integrated cement producer's costs, mining and nonmining, can be said to benefit its entire operation directly or indirectly. Both its mining and its nonmining costs are directed to the same ultimate goal, the sale of finished cement at a profit. That does not mean that recognized mining costs should be allocated in part to nonmining. By the same token, the costs of marketing the end product, which are recognizable nonmining costs, should not be allocated to mining. Only costs that benefit both phases of the producer's operation and are not directly identifiable with either a particular mining process or a particular nonmining process may be apportioned between mining and nonmining

expenses. Treasury Regulations, Section 1.613-4(d)(3)(iii), Br. App. 20a.

Here, the costs of bags, bagging, storage, distribution and sales have no functional relationship to respondent's mining activity and are incurred in the marketing processes long after the mining processes, as defined by the statute, have ceased. In accordance with the statute, the controlling Regulations provide that each of these costs are includible in the formula as nonmining costs. Indeed, in accordance with the statute and the rationale expressed by the Court of Claims, every court that has considered the costs of bags, bagging, storage and distribution has considered these costs to be nonmining costs (see our opening brief, at 24-25).

To be sure, some courts have held that selling costs should be allocated between nonmining and mining income. But as we have pointed out in our opening brief (at 25-26, n.13), those decisions antedated the 1972 Regulations that now explicitly provide that such selling expenses are nonmining costs absent a showing that nonintegrated miners incur the same costs. Since these costs relate to the marketing process of selling the finished cement, they are incurred long after the mining processes have ceased and have no functional relationship to them. Hence, under Section 613(c)(4), they must be treated as nonmining expenses. However, when it can be shown that nonintegrated miners incur selling costs to sell the raw materials, then the costs of selling may be allocated between mining and nonmining, in order to put the integrated miner-manufacturer on the same tax basis as the nonintegrated miner.[8] However, where,

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[8] Respondent's reference (Br. 33, 37) to trade association dues is misplaced. The parties agreed that the trade association dues were allocable between mining and nonmining costs

as here, there are no nonintegrated miners, then no part of the selling costs may be allocated to mining operations.[9]

To apportion all of respondent's costs involved between mining and nonmining, as it urges, would not only require the invalidation of the controlling Regulations, but would allocate part of the costs associated with nonmining processes and their related proceeds to the depletion base. What respondent seeks is nothing less than an expansive depletion allowance covering part of its nonmining income derived from marketing its manufactured end product. This Court should reject such an attempt to extend the depletion allowance beyond its intended purpose of compensating for the exhaustion of the mineral asset.

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

WADE H. MCCREE, JR.
Solicitor General

JANUARY 1981

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in accordance with Section 1.613-5(c)(6) of the Treasury Regulations (26 C.F.R.) on the theory that these dues benefitted both mining and nonmining processes rather than any particular process. The selling costs dealt only with the selling of the finished cement.

[9] The pre-1972 decisions permitting allocation of selling costs between mining and nonmining are not inconsistent with the 1972 Regulations. They assumed a fact that the Regulation requires to be proved. See our opening brief, at 25-26, n.13.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PORTLAND CEMENT COMPANY OF UTAH,
Respondent

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF OF AMICUS CURIAE

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BRIEF OF AMICUS CURIAE

INTEREST OF AMICUS CURIAE

Through its counsel, Richard A. Freling, David G. Glickman and William P. Bowers, Centex Corporation, acting as an amicus curiae, herewith submits this brief in support of the Respondent, Portland Cement Company of Utah, in the above-styled case now before the United States Supreme Court. Centex Corporation has an interest in the resolution of this case by reason of its ownership of integrated miner-manufacturers of cement.

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STATEMENT OF CASE

Finished cement is the product of both a mining and manufacturing operation. A business engaged in the production of cement is, therefore, engaged in both a mining and manufacturing operation and is commonly referred to as an integrated miner-manufacturer. To produce cement, the integrated miner-manufacturer may employ one of two operations: a "dry process" or a "wet process."

In the case at bar, the Respondent utilized the wet process to produce its cement. The mining phase of the wet process commences with the extraction of calcareous raw materials, continues as the extracted raw material is ground and blended with water, and ends with the production of a mixture referred to as "slurry" or "kiln feed." The manufacturing phase starts with the introduction of the kiln feed into a revolving kiln where the mixture is burned. The burned mixture is cooled and then ground together with additives to a fine powder, which is finished cement. The manufacturing phase terminates with the production of finished cement.

The Respondent sells finished cement either in bulk or in paper bags. When an order for bulk cement is received, the cement is loaded directly from storage silos into railcars or onto trucks. Finished cement sold in bags is conveyed from the silos to bagging machines, and after the bags are filled according to weight, the bags are loaded onto trucks or into railcars for shipment.

The Respondent charges a higher price for the cement sold in bags. This additional amount is referred to in the industry as the "bagging premium," which is intended to recompense the seller for the incremental costs incurred to bag the cement, *i.e.*, the cost of bags and bagging. With respect to the years in controversy, the premium was not sufficient for the Respondent to recoup the cost of the bagging operation and bags.

The Respondent sold both bulk and bag cement from its plant and from a distribution terminal. With respect to its products sold, the Respondent incurred selling expenses.

The case at bar involves a determination of the Respondent's depletion allowance for the years in controversy, which is calculated with reference to the Respondent's gross income from mining. Because the Respondent is an integrated miner-manufacturer of cement, and no market existed for its kiln feed, the calculation of its depletion allowance necessarily required that its gross income from mining activities be determined by an indirect method. The issues in this case focus on these calculations.

SUMMARY OF ARGUMENT

I. A. The Respondent, as an integrated miner-manufacturer of cement, is entitled to a depletion allowance based upon the gross income derived from its mining activities. If the Respondent operated only as a miner of the mineral material that is used in the manufacture of cement, its depletion allowance would be based simply upon the gross income it derives from its mining activities. However, in addition to mining the Respondent also engages in a manufacturing operation whereby it transforms the minerals it mines into finished cement. Without question, the Respondent cannot base its depletion allowance on all of the income it derives from the sale of the finished cement, because at least a portion of that income is attributable to the enhanced value of the minerals after manufacturing.

The singular question presented to the Court in the case at bar involves a determination of that portion of the income from the sale of finished cement attributable solely to the Respondent's mining activities. This determination might be based upon the value of the mineral after the application of only mining activities if a market existed for the mineral at that point. However, in the cement industry no market exists for such mineral unless it is further manufactured into cement. When no actual market exists for the mineral prior to the application of

manufacturing processes, a constructive market price may be determined by the "proportionate profits method." This method allocates gross income from finished cement between mining and manufacturing activities according to a formula based on the relative cost of each activity. *The assumption on which the proportionate profits method is based, stated explicitly in the Treasury Regulations, is that each dollar of the total cost paid to produce finished cement earns the same percentage of income.*

The specific issues involved herein relate to whether income and costs attributable to certain "post-manufacturing" processes applied to the finished cement are includible in the proportionate profits formula. These processes include the bagging, storage and distribution of the finished cement. The Respondent would *exclude* from the formula all income or costs attributable to these post-manufacturing processes. In contrast, the Petitioner would *include* in the formula all *post-manufacturing* costs and income from actual sales of both bulk cement and *further processed cement* (*e.g.*, bagged cement).

B. Both the Respondent and the Petitioner agree that the formula requires the inclusion of the income and cost of the product first marketed in significant quantities (*i.e.*, the "first marketable product"). The Respondent's first marketable product is bulk cement sold at its plant. Numerous cases involving the determination of a representative market or field price for a mineral have held that the first marketable product is the mineral sold in bulk, not the mineral sold in bulk and bag, and there is no reason to reach a different conclusion where the proportionate profits method is required to determine gross income from mining.

Bagging and other post-manufacturing processes are *processes applied to bulk cement* and, therefore, produce a second marketable product. Nothing in the law suggests that costs associated with processes applied *after* the first marketable product is produced or any income attributable thereto are properly includible in the proportionate profits formula. To the contrary, the Petitioner's assertion that such cost and income are

includible is contrary to the Treasury Regulation which in essence states that the *first marketable product does not include any product that is further processed.* Bagging and other post-manufacturing activities are defined in the Treasury Regulation as "processes," and they are clearly undertaken after the first marketable product is produced.

The accounting conventions utilized by the Respondent are consistent with the decision in *United States v. Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), *cert. denied*, 395 U.S. 936 (1969). The Petitioner's argument ignores the technical, economic and practical realities involved in the mining, manufacture and sale of cement, and if sustained will result in an unfair distortion of the Respondent's income.

C. To give effect to the assumption upon which the proportionate profits formula is based, the incremental income from and costs of the post-manufacturing processes must be excluded from the formula. Stated simply, after finished cement in bulk is produced, it is possible to determine precisely the cost and income attributable to any subsequent processes. Therefore, no approximation is necessary, and these items can and properly should be excluded from the formula.

The Petitioner insists that these incremental items of cost and income be included in the formula, even though this may negate the fundamental purpose of the formula, *i.e.*, to apportion income pursuant to the assumption that every dollar of cost produces the same percentage of income. Thus, even where the facts clearly demonstrate that the incremental costs produce little or, as here, no additional income, the Petitioner would include those costs in the formula. The formula was never intended to distort income in this manner.

II. If the position adopted by the Tenth Circuit permitting the complete exclusion of selling costs from the formula is rejected, the Treasury Regulations should be interpreted to permit a reasonable allocation of selling costs between mining and nonmining. The Petitioner arbitrarily maintains that no

reasonable allocation can be made in an industry populated exclusively by integrated miner-manufacturers. This position unjustifiably discriminates against such integrated miner-manufacturers. If the Petitioner's interpretation is correct, the Treasury Regulations should be held invalid as arbitrary and discriminatory.

ARGUMENT

I. THE INCREMENTAL INCOME AND COSTS ATTRIBUTABLE TO THE RESPONDENT'S POST-MANUFACTURING PROCESSES MUST BE EXCLUDED ENTIRELY FROM THE PROPORTIONATE PROFITS FORMULA.

A. Introductory Statement.

Section 611(a) of the Internal Revenue Code of 1954, as amended (hereinafter the "Code"), permits as a deduction in computing taxable income a reasonable allowance for depletion of mineral assets. Under Section 613(a) and (c) of the Code, the allowance for depletion is a specified percentage of the "gross income from the property" which, in the case of mineral property, means "gross income from mining."[1] Section 613(a) of the Code also limits the amount of the taxpayer's depletion allowance to 50% of the taxpayer's "taxable income from the property." The term "taxable income from the property" is defined as the taxpayer's gross income from mining, less all costs (excluding any deductions for depletion) attributable to the mining processes. Treas. Reg. §1.613-5(a).

The computation of "gross income from mining" depends on whether a nonmining process is applied to the extracted mineral before the mineral is sold. If the extracted mineral is sold before the application of a nonmining process, gross income from mining equals the actual amount for which the mineral is sold.

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[1]The depletion rate for calcium carbonate rock, from which cement is made, was 15% for the Respondent's taxable year ended March 31, 1970, and 14% for its taxable years ended March 31, 1971 and 1972. Section 613(b)(7) of the Code.

Treas. Reg. §1.613-4(b)(1). "If the mineral is sold after the application of a nonmining process, gross income from mining is the representative market or field price for which the mineral could have been sold before application of any nonmining processes, if such a representative market or field price existed. Treas. Reg. §1.613-4(c)(1). If it is impossible to determine a representative market or field price for the mineral before application of nonmining processes, gross income from mining is determined pursuant to the proportionate profits method. Treas. Reg. §1.613-4(d)(1)(i). The purpose of the representative market or field price and proportionate profits methods is the same: to separate the gross income from the sale of the final product into (i) gross income from mining with respect to which a taxpayer is entitled to an allowance for depletion, and (ii) gross income from nonmining with respect to which the taxpayer is not entitled to an allowance for depletion.

With respect to the cement industry, Congress has specifically provided in Section 613(c)(4)(F) of the Code that all processes applied prior to the introduction of the kiln feed into the kiln are mining processes and that processes incurred subsequent thereto are not mining processes. Because no representative market or field price exists for kiln feed, and nonmining processes therefore must be applied before the first marketable product is available, integrated miner-manufacturers of cement utilize the proportionate profits method to compute gross income from mining. *Ideal Basic, supra.*

The proportionate profits method is a cost-oriented approach which allocates gross income from the "first marketable product" between gross income attributable to the mining processes and gross income attributable to the nonmining processes, on the basis of the relative cost of each. In particular, the proportionate profits method is a mathematical equation consisting, in part, of a fraction of which (i) the numerator is the sum of all direct costs incurred as a result of mining processes, plus an allocable share of all indirect costs that are not directly identifiable with a mining or nonmining process, and (ii) the denominator is the sum of all direct costs that are incurred as a

result of both mining and nonmining processes required to produce the first marketable product, plus all allocable indirect costs that are not directly identifiable with a mining or nonmining process. Treas. Reg. §1.613-4(d)(4); *see also Standard Lime & Cement Co. v. United States*, 329 F.2d 939, 944 (Ct. Cl. 1964). The resulting fraction is multiplied by the integrated miner-manufacturer's gross sales (actual or constructive) of the first marketable product.[2] The proportionate profits equation may be represented as follows:

$$\frac{\text{Mining Costs (Direct and Allocable Indirect)}}{\text{Total Costs to Produce the First Marketable Product (Direct and Allocable Indirect)}} \times \text{Gross Sales of First Marketable Product} = \text{Gross Income From Mining}$$

The determination of the integrated miner-manufacturer's first marketable product is critical to a correct application of the formula. In particular, the integrated miner-manufacturer is entitled to compute its gross income from mining only with reference to the income earned from the sales of its *least* processed product, *i.e.*, its first marketable product, *North Carolina Granite Corp.*, 56 T. C. 1281, 1291 (1971), *acq.*, 1974-2 C.B. 3, *nonacq.*, 1974-2 C.B. 5, because the incremental income derived from any process applied thereafter may be determined

[2]If an integrated miner-manufacturer of cement sold a portion of its cement in bulk but also further processed part of its cement into concrete bricks, the cement sold in bulk would be the first marketable product. For purposes of the proportionate profits formula, the integrated miner-manufacturer's gross sales would be an amount equal to its actual sales of cement plus its constructive sales price for the cement further manufactured into concrete bricks. *See* Treas. Reg. §1.613-4(d)(4)(v).

from empirical data without resort to the proportionate profits method.[3] If the integrated miner-manufacturer further processes a portion of its first marketable product, the gross sales to be used in the proportionate profits formula is the sum of (i) the proceeds from the actual sales of the first marketable product, and (ii) the proceeds from the constructive gross sales of the first marketable product which was further processed.[4] Moreover, since only costs incurred to produce the first marketable product are includible in the proportionate profits fraction, the cost attributable to any processes applied subsequent to the production of the first marketable product is excluded entirely from the fraction (*i.e.*, such cost is excluded from both the numerator and denominator).

The singular purpose of the proportionate profits formula is to provide an integrated miner-manufacturer with a constructive market price for a mined product, when no market price otherwise exists for that product. This formula does not utilize empirical data to determine the constructive market price of a particular product, but rather is an estimation employing the fiction that each dollar of the total cost paid to produce and sell the first marketable product earns the same percentage of profits. Treas. Reg. §1.613-4(d)(4). In general, this fiction serves adequately as a means of separating gross income from the first marketable product into its two components: gross income from *mining*, with respect to which the taxpayer is entitled to a depletion allowance, and gross income from *manufacturing*, with respect to which the taxpayer is not entitled to a depletion allowance.

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[3] Because there is a market for bulk finished cement, any profit or loss resulting from subsequent processes can be determined precisely by comparison of the increase in price over that of bulk cement with the additional expenses incurred in applying the subsequent processes.

[4] Treas. Reg. §1.613-4(d)(4)(v) clearly contemplates the use of a constructive sales price for that portion of the first marketable product that is further processed in the taxpayer's operation. The same result obtained under the Treasury Regulations promulgated pursuant to the Internal Revenue Code of 1939, as amended. Treas. Reg. 118, §39.23(m)-1(e)(3).

In the case at bar, the Petitioner and the Respondent apparently agree as to the proper treatment within the proportionate profits method of direct costs incurred in connection with the mining or manufacturing processes. The threshold issues in this case are whether (i) the incremental cost associated with the post-manufacturing processes (*e.g.*, bagging, storage and distribution) are properly includible in either the numerator or the denominator of the proportionate profits fraction, and (ii) the incremental income from such processes are properly includible in the gross sales component of the formula.

The Petitioner asks the Court to extend the use of the proportionate profits formula beyond the purpose for which it is intended, so as to diminish the Respondent's gross income from mining. In particular, the Petitioner's method distorts the calculation by attributing income to post-manufacturing processes that without question are applied after the production of the first marketable product, *i.e.*, finished cement, even though these processes are demonstrably less profitable per unit than the mining and manufacturing operations and actually may result in a loss. The application of the formula urged by the Petitioner is clearly erroneous as applied to integrated miner-manufacturers of cement. *Ideal Basic, supra.*

B. The Incremental Income and Costs Incurred Subsequent to the Production of Finished Cement Must be Excluded from the Proportionate Profits Formula, Since the Respondent's First Marketable Product is Finished Cement Sold in Bulk at its Plant.

As noted previously, the proportionate profits formula is designed with explicit reference to the first marketable product. Stated differently, the *raison d'etre* of the formula is that it should be applied to the integrated miner-manufacturer's *least* refined or finished product for which a market exists. *North Carolina Granite Corp., supra,* 56 T.C. at 1291. The Court of Appeals for the Tenth Circuit, in *Ideal Basic, supra,* 404 F.2d at 125-26, held that the first marketable product of an integrated miner-manufacturer of cement is bulk cement and that bagged

cement is a second marketable product (*i.e.*, a more refined product than the first marketable product).[5]

The Petitioner contends that the Respondent's first marketable product is cement sold in bulk or bag and that the gross sales amount in the proportionate profits formula therefore must include the Respondent's actual total gross sales, whether in bulk or bags. Because the Petitioner applies the proportionate profits formula to the Respondent's actual sales, rather than to the actual or constructive sales of finished cement in bulk, it insists upon including bagging costs in the proportionate profits fraction, even though such costs are incurred after the production of cement, which the Petitioner concedes is a first marketable product. Moreover, because such incremental costs are incurred after the production of "kiln feed," the Petitioner concludes that they are nonmining costs that are includible only in the denominator of the proportionate profits fraction.

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[5]Other than *Ideal Basic, supra,* and the opinions below in the case at bar, only two cases have actually addressed the issue of whether finished cement in bulk is the first commercially marketable product. The Ninth Circuit in *United States v. California Portland Cement Co.*, 413 F.2d 161 (9th Cir. 1969), held without a discussion of the issue that the first marketable product was cement in bulk or bag, citing as authority the Treasury Regulations and *Whitehall Cement Manufacturing Co. v. United States*, 369 F.2d 468 (3rd Cir. 1966). In *General Portland Cement Co. v. United States*, 628 F.2d 321 (5th Cir. 1980), the Fifth Circuit followed *California Portland* and *Whitehall Cement*, stating that *Ideal Basic* was wrongly decided as a result of the Tenth Circuit's misplaced reliance on *Standard Lime, supra,* and *United Salt Corp.*, 40 T.C. 359 (1963), *acq.*, 1973-2 C.B. 4, *aff'd*, 339 F.2d 215 (5th Cir. 1964). *But see* discussion of *United Salt, infra* at page 13.

In *Whitehall Cement*, the Third Circuit held only that *finished* cement was the first marketable product and that the incremental income and cost of the bagging operation must be included in the formula because the overall profits from the sale of bagged cement were attributable at least in part to the bagging process. This point is addressed *infra* at page 18. In *Standard Lime*, the Court of Claims expressly stated that it was not deciding whether bulk cement was the first marketable product. Neither *Mississippi Valley Portland Cement Co. v. United States*, 347 F. Supp. 240 (S.D. Miss. 1972), nor *Southwestern Portland Cement Co. v. United States*, 435 F.2d 504 (9th Cir. 1970), both cited by the Petitioner, expressly addressed the issue of first marketable product.

The Respondent asserted in the courts below that its first marketable product is bulk cement alone and that, therefore, the gross sales amount in the proportionate profits formula must be based upon the income it receives from the actual gross sales of bulk cement at its plant and the constructive gross sales of the bulk cement that was further processed. *Portland Cement Company of Utah v. Commissioner,* 614 F.2d 724 (10th Cir. 1979), *cert. granted*, 101 S. Ct. 69 (1980). Accordingly, the Respondent would exclude the bagging premium from the gross sales amount to which the proportionate profits fraction is applied and would also exclude the bagging costs from the proportionate profits fraction entirely.

Contrary to the Petitioner's assertion, the Respondent's first marketable product is only bulk cement, and not bulk and bag cement. This position finds clear support in Treas. Reg. §1.613-4(d)(4)(iv), which defines the term "first marketable product" as the product produced by the integrated miner-manufacturer in a form in which such product is first marketed in significant quantities. In that regard, it would appear indisputable that cement in bulk is the Respondent's product first marketed in significant quantities. While the Petitioner does not deny this conclusion, it asserts that cement in bag is essentially the same product as cement in bulk and that cement in bulk and bag therefore is the same marketable product. As will be discussed hereinafter, the Petitioner relies on Treas. Reg. §1.613-4(d)(4)(iv) to support this argument.

The Petitioner's assertion that cement in bulk and bag is the same marketable product denies the reality that cement in bulk must be processed further in order to become bagged cement. The Petitioner's own Treasury Regulations provide that the application of a nonmining process to the first marketable product creates a different product, no longer the first marketable product, and that bagging is such a nonmining process. Treas. Reg. §§1.613-4(d)(4)(iv) and 1.613-4(g)(4). Although the bagging process admittedly does not alter the physical or chemical characteristics of the cement in bulk (which, as noted hereinafter, appears to be the principal basis for the

Petitioner's position), it is nonetheless a nonmining process applied to cement in bulk that results in additional cost and income, and therefore, according to the Treasury Regulations, *bagged cement is not the first marketable product.*

The position that the Respondent's first marketable product is cement in bulk finds support in case law. As stated above, the court in *Ideal Basic, supra,* held that bulk cement is the first marketable product and that bagged cement is the second marketable product. 404 F.2d at 126. In the case at bar, that court reiterated its *Ideal Basic* holding that the first marketable product of an integrated miner-manufacturer of cement is bulk cement. While the Petitioner now rejects the simple logic of these decisions, it is interesting to note that, when it suited its purpose, the Petitioner has argued that bulk cement, and not bagged cement, is an integrated miner-manufacturer's first marketable product. *Standard Lime, supra,* 329 F.2d at 945, 948.

Furthermore, several cases that involved the determination of a representative market or field price for a mineral have held that the first marketable product is the mineral sold in bulk form, and that gross income from mining should be determined as if all of the product had been sold in bulk form. For example, in *Standard Realization Co. v. United States,* 289 F.2d 247 (7th Cir. 1961), the taxpayer argued that its gross income from mining was properly computed by reference to its actual sales of silica sand and flour in both bulk and bag. The Court of Appeals for the Seventh Circuit was unpersuaded by the taxpayer's argument, and stated that "it is hardly open to question but that taxpayer's product [in its raw state] was ready for industrial use or consumption . . . ." 289 F.2d at 254. As a result, the court concluded that the taxpayer's depletion base was the gross income it received from the sale in bulk of unground silica sand and flour in bulk and what it would have received if all its product had been sold in that form. Bagged sand was, in the court's words, "a more refined product." 289 F.2d at 254.

The Tax Court in *United Salt, supra,* agreed with the Seventh Circuit's decision in *Standard Realization.* The Tax Court considered a factual situation wherein a producer of salt sold its product in both bulk and bag. The Commissioner's position was that the producer's gross income from mining must be based on the total tonnage of salt sold, figured at the unit price for bulk salt.[6] The Tax Court agreed with the Commissioner, stating that bulk salt was the first marketable product and that, therefore, the bagged product was an additionally processed product, the income from which was not includible in gross income from mining. 40 T. C. at 368. *See also Ayers Materials Co.,* 62 T. C. 557 (1974); *Dravo Corp. v. United States,* 348 F.2d 542 (Ct. Cl. 1965).

Although *Standard Realization, supra,* and *United Salt, supra,* involved nonintegrated miners using representative market or field prices to determine gross income from mining, the logic that supports the conclusions of those cases is equally compelling when applied to an integrated miner-manufacturer of cement using the proportionate profits method. The Respondent's first marketable product is finished cement as it is produced by the manufacturing process. At that point, the cement may be and is in fact sold. The income to be derived from the finished cement is properly determined on a per ton basis at the Respondent's plant. *Ideal Basic, supra,* 404 F.2d at 126. Viewed from this perspective, it is at once apparent that the bagging process is a process applied to the Respondent's first marketable product, finished cement. Notwithstanding the Petitioner's assertion to the contrary, it is submitted that there is no justification for the Petitioner's position that the Respondent

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[6]It is interesting that in *United Salt* the Commissioner argued that "the costs of sacking and sewing" marketable salt were not includible in the depletion base, 40 T. C. at 368, with the obvious results of decreased depletion and increased tax revenues. Here, in contrast, where a virtually identical argument would reduce revenues, the Petitioner renounces its prior position and asserts that the costs of bagging finished cement must be included, through the proportionate profits formula, in the depletion base.

must include in gross sales the incremental income from its bagging or any other process applied after the production of its first marketable product, finished cement in bulk.

To justify lumping bulk cement and bagged cement together as a single first marketable product, the Petitioner relies on Treas. Reg. §1.613-4(d)(4)(iv), which provides, *inter alia,* that bulk and packaged products are considered to be essentially the same product. Aside from this perfunctory conclusion of the Treasury Regulations, the Petitioner's position is based on a single proposition which may be stated thus: the nature of the first marketable product depends solely upon its physical and chemical characteristics, and because cement sold in bags has the same physical and chemical characteristics as cement sold in bulk, they are both the same first marketable product.

As support for that proposition, the Petitioner relies exclusively on *United States v. Cannelton Sewer Pipe Company,* 364 U.S. 76 (1960), wherein this Court was asked to determine the first commercially marketable product of a taxpayer that mined clay for use in the production of its vitrified sewer pipe. Under the then applicable depletion allowance provisions,[7] the term mining included not only the extraction of minerals from the ground but also the ordinary treatment processes normally applied by mine owners to obtain a *commercially marketable product.* The Government contended that the taxpayer's first commercially marketable product was the mined clay, since substantial quantities of clay were mined and sold in the taxpayer's marketing area. In contrast, the taxpayer asserted that its first commercially marketable product was the vitrified sewer pipe, since it could not sell its mined clay at a profit but had to process the clay further in order to earn a profit. This Court held in favor of the Government, stating that the term "commercially marketable product" meant the mineral first

[7]Internal Revenue Code of 1939, Section 114(b)(4)(B). The provisions of that Section were essentially carried over into Section 613(c) of the Code as it existed prior to the Public Debt and Tax Extension Act of 1960, Pub. L. 86-564, 86th Cong., 2d Sess.

produced by mining processes which was ready for industrial use or consumption, regardless of whether it could be marketed at a profit. 364 U.S. at 86. By way of *obiter dictum*, this Court commented that mining processes (as opposed to manufacturing processes) were those processes that did not destroy the physical or chemical identity of the minerals. 364 U.S. at 85-86.

The Petitioner relies on this *dictum* for the proposition that all products are identical if their physical and chemical properties are the same. All that *Cannelton* states, however, is that a manufacturing process causes a physical or chemical change in the raw mineral which exists after the application of mining processes. Contrary to the Petitioner's assertion, it does not follow from this *dictum* that *only* physical and chemical changes produce different products. At most, this Court in *Cannelton* found that a physical or chemical change in the raw mineral was one way to produce a different product. Stated simply, this Court did not address the issue of whether post-manufacturing processes (that admittedly do not alter the physical or chemical nature of a product) result in different marketable products.

The relevance of *Cannelton* to the proposition for which the Petitioner cites it is further diminished by the fact that, subsequent to the decision, Congress amended the depletion allowance provisions by removing the phrase "commercially marketable product."[8] Rather than leave open the question of when first marketability exists for any particular mineral, Congress listed the cut-off point for mining operations applicable to the various minerals, and thereby established the point at which the mining processes end. It is Section 613(c) of the Code, as presently in force and effect, that is involved in the case at bar. Under Section 613(c)(4)(A), (B) and (C) of the Code, the cut-off point (or last mining process) for coal, sulphur, and minerals sold in the form of crude minerals is the loading for shipment of those minerals. Accordingly, a miner that extracts those minerals may

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[8]Public Debt and Tax Extension Act of 1960, Pub. L. 86-564, 86th Cong., 2d Sess.

compute its gross income from mining with reference to the gross sales price of those minerals loaded for shipment to the purchaser. Obviously, if the phrase "loaded for shipment" includes the mineral loaded in bulk, but not in bag, the miner's marketable product in bulk is a different marketable product than its marketable product in bag.

While Section 613 of the Code is silent as to whether the phrase "loaded for shipment" includes the mineral loaded in bag as well as bulk, the Treasury Regulations promulgated thereunder support the argument that the miner's marketable product is the mineral in bulk, and thus is the product with respect to which the representative market or field price is determined. Specifically, Treas. Reg. §1.613-4(g)(4) provides that packaging and the processing necessary or incidental thereto are *nonmining processes.* Applying that provision of the Treasury Regulations, the Petitioner has ruled that bagging is not part of loading for shipment as described in Section 613(c)(4) of the Code, but rather is a process applied subsequent to the point at which the representative market or field price of the mineral is determined. Accordingly, the income attributable to the bagging process is not includible in gross income from mining. *See* Rev. Rul. 72-476, 1972-2 C.B. 288; *Standard Realization, supra; United Salt, supra.*

It follows from the foregoing that bagging is a process applied to the miner's first marketable product in bulk and produces a *different* (or second) marketable product, notwithstanding the fact that the bagging process does not alter the physical or chemical nature of the mineral in bulk. The treatment for the minerals listed in Section 613(c)(4)(A), (B) and (C) of the Code demonstrates the fallacy of the Petitioner's argument that cement in either bulk or bag is the same marketable product.

For the foregoing reasons, we submit that the Respondent's first marketable product is bulk cement at the plant; bagged cement is a more refined and, therefore, second marketable product. It is not necessary to overrule Treas. Reg. §1.613-4(d)(4)(iv) in order to conclude that the Respondent's first

marketable product is bulk cement at the plant, and not bagged cement. In fact, the Tenth Circuit in *Ideal Basic*, applying regulations substantially identical to Treas. Reg. §1.613-4(d)(4)(iv), *see Portland Cement Co., supra*, 614 F.2d at 724, as well as in the case at bar, reached just that conclusion, and found bagged cement to be a *second* marketable product. Obviously, the provision in Treas. Reg. §1.613-4(d)(4)(iv) upon which the Petitioner relies so heavily, *i.e.*, that bulk *and* bagged product is the first marketable product, is only a generalized statement to be applied as facts and circumstances dictate. The facts and circumstances in the case at bar dictate that bulk and bagged cement be distinguished as different marketable products.

However, if the Petitioner insists that Treas. Reg. §1.613-4(d)(4)(iv) states a universal rule that would classify both bulk and bagged cement as the first marketable product, it is submitted that the Regulation is contrary to law and must be held invalid. The Treasury Department may not promulgate an arbitrary or unreasonable regulation. *United States v. Cartwright*, 411 U. S. 546 (1973); *Russell Manufacturing Co. v. United States*, 175 F. Supp. 159 (Ct. Cl. 1959). Nor should the Treasury Department be permitted to alter the law by regulatory fiat. As discussed above, the Petitioner's sole justification for the proffered application of Treas. Reg. §1.613-4(d)(4)(iv) is the *obiter dictum* in *Cannelton, supra*. As explained, this reliance on *Cannelton* is misplaced, because the case does not support the assertion that Treas. Reg. §1.613-4(d)(4)(iv) requires that bulk and bagged cement be considered the same marketable product. Moreover, it has been demonstrated that, for purposes of computing a representative market or field price, the bulk product is the first marketable product. In that respect, there simply is no justification for treating the bulk product as the first marketable product for purposes of determining a representative market or field price but not for purposes of the proportionate profits formula, except merely to raise additional tax revenues. Accordingly, it is submitted that the holdings of the Tax Court and Tenth Circuit in the case at bar should be affirmed.

C. The Incremental Income from and Costs of the Post-Manufacturing Operation Must Be Excluded Entirely from the Formula in Order to Give Proper Effect to the Assumption upon Which the Proportionate Profits Method Is Based (*i.e.*, Every Dollar of Cost Earns the Same Percentage of Profit).

As noted previously, the proportionate profits formula is based on a fiction that attributes a portion of the profit from the first marketable product to each dollar of cost incurred to produce and sell that product. With respect to mining and manufacturing costs, this fiction is one of necessity and convenience, since there is no empirical data to determine what percentage of the profits is attributable to these costs. However, when the processes are applied subsequent to the production of the first marketable product, it is possible to determine whether the subsequent processes earned profit. *See* note 3, *supra.*

In the case at bar, the costs attributable to the post-manufacturing processes were demonstrably less profitable than the costs of mining and manufacturing. Specifically, it is clear that the Respondent did not recover the incremental cost it incurred as a result of its bagging and distribution processes. To the contrary, the parties have stipulated that the bagging premium in each of the years in question was less than the cost of bagging and the bags, and, apparently, the cost of the distribution process was completely absorbed by the Respondent (*i.e.*, none of the cost of the distribution process was passed along to the purchasers). As a result, such incremental costs did not produce any *additional* profit for the Respondent. Instead, these costs resulted in a loss that diminished the Respondent's profits which it otherwise would have realized from sales of bulk cement at its plant.

When the facts establish that post-manufacturing processes do not earn a proportionate amount of the profit, the assumption on which the proportionate profits formula is based is violated unless (i) the fraction in the formula includes only the mining and manufacturing cost incurred by the Respondent to produce finished cement in bulk, and (ii) the gross sales in the formula

include only the total of the Respondent's actual gross sales of cement in bulk, plus the constructive gross sales of bulk cement further processed.

The Petitioner rejects calculating the constructive sales price in this manner because it asserts that such a calculation would be based on an erroneous assumption that the cost of the Respondent's post-manufacturing processes earns only the incremental income derived from the processes. More specifically, the Petitioner asserts that, if cement in bulk is sold for $100 per ton and in bag for $110 per ton (*i.e.*, a $10 per ton bagging premium) and the bagging costs are $15 per ton, the bagging cost earns not only the bagging premium of $10 but also a portion of the $100 sales price assigned to bulk cement.

As a basis for that assertion, the Petitioner states that it is reasonable to infer that the integrated miner-manufacturer's sale of the bagged product was an accommodation to the purchaser, induced sales, and contributed at least a portion of the profit. More specifically, the Petitioner asks the Court to infer that the Respondent would not have engaged in the unprofitable bagging process except as a means of realizing a portion of the profit from the ultimate sale, and that, therefore, the Respondent's unprofitable bagging operation should be deemed to have earned a portion of the profit from the ultimate sale.[9] For the following reasons, it is submitted that the Petitioner is in error with respect to its treatment of demonstrably unprofitable processes.

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[9] In *Standard Realization, supra,* 289 F.2d at 253-255, and *United Salt, supra,* 40 T.C. at 366, the courts implicitly rejected the notion that any portion of the overall profit from the sale of the bagged product must be allocated to the bagging process, even though the product could not have been sold without first bagging the bulk product. Additionally, the inference has been rejected by the Petitioner's own Treasury Regulations as they apply to "purchased transportation" (which is transportation of the product to the customer in conveyances not owned by the taxpayer and with respect to which the taxpayer ordinarily does not earn any profit). Specifically, Treas. Reg. §1.613-4(e)(2) provides that the incremental income and cost attributable to purchased transportation shall be excluded entirely from the formula (*i.e.*, the incremental income is not included in gross sales and the incremental cost will be excluded from the denominator).

1. The Petitioner's suggested inference ignores the facts in the case at bar. Specifically, the record is silent as to the Respondent's specific reasons for incurring the bagging or other post-manufacturing costs. The Petitioner would have the Court hold that the Respondent would not have incurred the post-manufacturing cost if it could have sold all of its product in bulk at the plant. This unsupported conclusion is not justified. From an overall business viewpoint the Respondent may have had a variety of valid business reasons for incurring the bagging cost. For example, the Respondent may have chosen to incur the cost in order to increase customer goodwill or develop new markets.

2. In addition, the inference suggested by the Petitioner with respect to demonstrably unprofitable costs was flatly rejected by this Court in *Cannelton*, wherein the integrated miner-manufacturer asked the Court to infer that it would not have engaged in its unprofitable mining operation except as a means to realize a portion of the profit from the ultimate sale of its manufactured product and, therefore, that the integrated miner-manufacturer's unprofitable mining operation should be deemed to have earned the profit from the ultimate sale of the manufactured product. This Court held that the integrated miner-manufacturer's depletion allowance must be based on the representative market or field price of the first commercially marketable product of its mining operation, even though it could not sell the first commercially marketable product at a profit, but had to process the product further in order to make a profit. More specifically, this Court rejected the integrated miner-manufacturer's allocation of profit from the manufacturing operation to the unprofitable mining operation.

The plain meaning of this Court's holding in *Cannelton* is that when no profit is earned from a particular process, the unprofitable process may not be treated as earning any portion of the profits derived from a different process. Although *Cannelton* involved the determination of the integrated miner-manufacturer's first commercially marketable product, the

concept that this Court rejected there is identical to the concept that the Petitioner now asks the Court to apply in the context of the proportionate profits method.

3. The Petitioner's suggested inference also ignores the holdings of several courts that have addressed the issue and concluded that the incremental costs and income of less profitable processes must be eliminated completely from the formula. For example, in *North Carolina Granite, supra*, the Tax Court considered a factual situation involving an integrated miner-manufacturer of granite products. The taxpayer's nonmining operations took place in two separate departments (*i.e.*, Department I and Department II), both of which used rough granite mined from the taxpayer's quarries. Department I and Department II applied different nonmining processes to produce their respective finished products. The nonmining processes applied by Department II were more costly than the nonmining processes applied by Department I, and as a result, Department II produced little or no profit. In considering the correct application of the proportionate profits formula to that factual situation, the court concluded that:

> it is clear that not every dollar of cost in [taxpayer's] operations produced the same amount of profit. [Department II's] nonmining costs produced little or no profit when compared to the production of [Department I's] nonmining costs, and the inclusion of [Department II's] nonmining costs in the proportionate profits formula skews its results unfairly in the direction of nonmining gross income.

56 T.C. at 1290.

Contrary to the Commissioner's insistence that the proportionate profits formula must include the nonmining costs of the less profitable Department II, the Tax Court directed the parties to include in the formula only the costs of Department I. To avoid including the less profitable costs in the formula, the Tax Court found that Department I's product was the first

marketable product, *even though Department I's product was not used in or additionally refined by Department II.* In particular, the court found that the costs of the taxpayer's *least refined product* were the costs properly includible in the proportionate profits formula.

Applying the rationale of *North Carolina Granite* to the case at bar, it is clear that the incremental income (if any) and costs from the Respondent's post-manufacturing processes of bagging and distribution must be eliminated from the proportionate profits fraction. Specifically, the proportionate profits fraction should be constructed with reference to the Respondent's mining and manufacturing operations, since cement sold at the plant in bulk is the least refined product and the post-manufacturing processes of bagging and distribution are demonstrably less profitable (if profitable at all) than the mining and manufacturing operations. To include in the formula the incremental cost and profit attributable to the bagging and distribution processes would, in the words of the Tax Court, "skew its results unfairly in the direction of nonmining gross income." 56 T.C. at 1290.

The holding in *North Carolina Granite* is further supported by *United States v. Portland Cement Company of Utah,* 378 F.2d 91 (10th Cir.), *cert. denied,* 389 U.S. 975 (1967), wherein Judge Breintenstein, writing for the majority, stated:

> If the inclusion of unproductive costs so distorts the equation that the application of the formula does not in fact clearly reflect the gross income from the property they may be excluded.

378 F.2d at 94.

4. Unless the incremental cost and income attributable to post-manufacturing processes are eliminated from the proportionate profits formula, the taxpayer who calculates gross income from mining by reference to a representative market or

field price may receive a decided tax advantage over the taxpayer who calculates gross income from mining by use of the formula. This disparate treatment may be stated thus: in the proportionate profits formula, bagging costs are deemed to have earned not only the bagging premium, but also a portion of the income which would have been received had the mineral been sold in bulk, whereas a representative market or field price calculation may be based on the constructive sales price of the mineral in bulk, with no portion of that price attributed to the bagging costs.[10] To the extent the Regulations require this discriminatory result, they must be found to be invalid, since such disparate treatment should not exist between those that use the representative market price and those that use the proportionate profits method.

This point may be illustrated by the example in Appendix A, which compares an integrated miner-manufacturer in an industry where a representative market price exists for the mineral before nonmining processes and an integrated miner-manufacturer in an industry required to use the proportionate profits formula.

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[10]The requirements regarding the calculation of a representative market or field price are set forth in Treas. Reg. §1.613-4(c). Of specific interest is Treas. Reg. §1.613-4(c)(6), which provides: "It shall be presumed that a price is not a representative market or field price for the taxpayer's ore or mineral if the sum of such prices plus the total of all costs of nonmining processes . . . which the taxpayer applies to his ore or mineral regularly exceeds the taxpayer's actual sales price of his product." If this requirement cannot be satisfied, the taxpayer must use the proportionate profits method to calculate its gross income from mining attributable to the nonmining processes.

In the example in Appendix A, the integrated miner-manufacturer broke even on its bagging process and, therefore, would be entitled to compute its gross income from mining under the representative market or field price method, notwithstanding the provisions of Treas. Reg. §1.613-4(c)(6). However, even if the integrated miner-manufacturer's bagging cost exceeded the bagging premium, it should be entitled to compute its gross income from mining not by use of the proportionate profits method, but by use of the representative market or field price method, because Treas. Reg. §1.613-4(c)(6) is an arbitrarily discriminatory provision and should be found invalid.

The unconscionable nature of Treas. Reg. §1.613-4(c)(6) has been described by one commentator as follows:

> In this provision the Commissioner takes a "heads I win, tails you lose" attitude. If the transportation or conversion operation results in

5. Finally, the proportionate profits formula as applied by the Petitioner to determine the Respondent's "gross income from mining" further compounds the inequitable treatment described above by adversely affecting the Respondent's depletion allowance with respect to its sale of *bulk* cement. Specifically, in the formula that the Petitioner seeks to apply, *bagging costs* are considered to have earned a portion of the profits from *bulk* sales of cement, notwithstanding that the bulk sales were totally unrelated to the bagging costs. In particular, in the proportionate profits fraction every dollar of cost is deemed to have earned an allocable share of gross sales. Thus, if the denominator includes bagging costs and gross sales includes both bagged and bulk sales (as the Petitioner contends), the bagging costs are deemed to have earned not only a portion of sales attributable to bagged sales but also a portion of the sales attributable to bulk sales. This is clearly contrary to the facts as indicated in the record of this case: the bagging costs did not earn any portion of the bulk sales, but were incurred in separate and unrelated sales. This point is illustrated by the example in Appendix B.

> a substantial profit, no part of that profit increases the gross income of the property; but if the transportation or conversion operation results in a loss, that loss reduces gross income from the property. It is difficult to understand why this result should follow. I can understand that the taxpayer should not be allowed to treat as gross income from the property an amount which is actually attributable to a transportation or conversion process, but once the taxpayer is able to demonstrate that the transportation or conversion process actually did produce a loss, whatever the reason, that loss should not then be attributed to the producing operation and result in a reduction of the gross income from the property.

Collier, "The New Depletion Regulations," 1970 Tulane Tax Institute 510, 530 (1970).

The test set forth in Treas. Reg. §1.613-4(c)(6) is not relevant to a determination of the actual representative market or field price. Assuming that a price is otherwise representative, the fact that the producer may incur a loss in connection with a subsequent process is irrelevant. Congress enacted Section 613 of the Code to compensate the miner for the exhaustion of his mineral asset based on the income derived from constructive sales of the raw mineral product. *Cannelton, supra.* The profitability of processes applied subsequent to the constructive sale bears no relation to the producer's depletion deduction.

It is clear that only the mining and manufacturing costs incurred in connection with the sale of bulk cement may be properly included in the proportionate profits formula used to determine gross income from mining of bulk cement. Any other result would be contrary to this Court's decision in *Cannelton, supra,* wherein the Court noted that gross income from mining must not contain any element of cost or profit attributable to a nonmining or finishing process. The Court's postulate stated in the converse is that gross income from manufacturing must not contain any element of cost or profit attributable to a mining process. In the case at bar, as in the example in Appendix B, the Petitioner's position has the effect of attributing a portion of the mining income to nonmining processes. Contrary to this Court's opinion in *Cannelton, supra,* it denies the taxpayers the income attributable solely to the mining process.

For the reasons stated in paragraphs 1 through 5, it is submitted that the incremental income and costs of the post-manufacturing operation must be excluded entirely from the formula in order to give effect to the assumption of the proportionate profits formula (*i.e.*, every dollar of cost earns the same percentage of income).

II. THE RESPONDENT'S SELLING EXPENSES ARE NOT IDENTIFIABLE WITH EITHER A MINING OR NONMINING PROCESS. ACCORDINGLY, SELLING EXPENSES MUST BE APPORTIONED BETWEEN MINING AND NONMINING BY A REASONABLE METHOD, UNLESS THE DECISIONS OF THE TENTH CIRCUIT ARE FOLLOWED AND SELLING EXPENSES ARE EXCLUDED ENTIRELY FROM THE PROPORTIONATE PROFITS FRACTION.

The Tenth Circuit in *Ideal Basic, supra,* 404 F.2d at 126, and in the case at bar, excluded selling expenses entirely from the

proportionate profits fraction (*i.e.*, selling expenses were not included in either the numerator or denominator of the fraction). This position is not the one indicated by Treas. Reg. §§1.613-4(d)(4)(iii) and 1.613-5(c)(4)(ii), which permit only an allocation of selling costs between mining and nonmining, but is required by *Ideal Basic* and the opinion below. The Petitioner's position is not only contrary to that of the Tenth Circuit, but is also inconsistent with the Treasury Regulations cited above, and is most onerous to the Respondent and all other integrated miner-manufacturers of cement, in that it would disallow any allocation of the selling expenses between mining and nonmining. The remainder of this *amicus curiae* brief will be directed toward the proposition that, at the very least, such selling expenses must be prorated between mining and nonmining in the proportionate profits formula.

Treas. Reg. §1.613-4(d)(4)(iii) and the decisions of the Ninth Circuit and Fourth Circuit require that the Respondent allocate the selling costs between its mining and manufacturing processes based upon a reasonable method.[11] The Petitioner objects, however, to any allocation of selling costs to the mining process, unless the Respondent can demonstrate that selling costs are typically incurred by a *nonintegrated* miner of cement, *i.e.*, a miner engaged in selling its mineral before the application of any nonmining processes. In the case at bar, the Petitioner contends that the Respondent has failed to show that a nonintegrated miner of cement typically incurs selling costs.

For the Respondent, and all other integrated miner-manufacturers of cement, the Petitioner's position creates an anomaly which may be stated thus: an integrated miner-manufacturer of cement cannot demonstrate that a nonintegrated miner of cement typically incurs selling expenses, since the cement industry is fully integrated, *i.e.*, there are no nonintegrated miners of kiln feed. In essence, the Petitioner argues that, for fully integrated industries, there is an

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[11] *Southwestern Portland Cement, supra,* 435 F.2d at 508; *Arvonia-Buckingham Slate Co. v. United States,* 426 F.2d 484, 486 (4th Cir. 1970); *California Portland, supra,* 413 F.2d at 170.

irrebuttable presumption that no reasonable method may be established for the allocation of selling expenses between mining and nonmining processes. Such an irrebuttable presumption is arbitrary and unreasonable and has been rejected implicitly by the courts.[12] Furthermore, the result sought by the Petitioner is not required by the Treasury Regulations.

The Petitioner relies exclusively on Treas. Reg. §§1.613-4(d)(4)(iii) and 1.613-5(c)(4)(ii). Treas. Reg. §1.613-4(d)(4)(iii) provides that costs that are not directly identifiable with a mining or nonmining process must be apportioned between mining and nonmining by use of a reasonable method. For the rule with respect to selling expenses, Treas. Reg. §1.613-4(d)(4)(iii) refers to Treas. Reg. §1.613-5(c)(4)(ii), which provides that for purposes of computing taxable income from the property (*i.e.*, gross income from mining less mining cost), an integrated miner-manufacturer must deduct as a mining cost a reasonable portion of its selling expenses.

The purpose of Treas. Reg. §1.613-5(c)(4)(ii) is to maintain equality between an integrated miner-manufacturer and a nonintegrated miner in the same industry with respect to the computation of taxable income from the property. To that end, Treas. Reg. §1.613-5(c)(4)(ii) requires an integrated miner-manufacturer to reduce its gross income from mining by that portion of its selling expenses which equals the typical selling expenses incurred by a nonintegrated miner in the same industry. If a nonintegrated miner in the industry does not incur selling expenses, the integrated miner-manufacturer in that same industry is not required in computing taxable income from the property to reduce its gross income from mining by any portion of its selling expenses.

The above-referenced Treasury Regulations neither state explicitly nor imply that the integrated miner-manufacturer in a fully integrated industry is precluded from allocating a reasonable portion of its selling expense to its mining operation. Indeed, Treas. Reg. §1.613-5(c)(4)(ii) is silent on that point,

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[12] *See* note 11, *supra*.

because the policy underlying that provision (*i.e.*, to maintain equality between the integrated and nonintegrated miner in the same industry) is not applicable to the fully integrated industry. Accordingly, the Respondent must follow the general provisions of Treas. Reg. §1.613-4(d)(4)(iii) regarding expenses not directly identifiable with a mining or nonmining process and allocate its selling expenses between mining and nonmining on a reasonable basis. As hereinafter discussed, the courts have held that, in the cement industry, a reasonable method of allocation may be on the ratio of direct mining cost to total mining and manufacturing cost.[13]

If, notwithstanding the foregoing argument, Treas. Reg. §1.613-4(d)(4)(iii) by its reference to Treas. Reg. §1.613-5(c)(4)(ii) is read as precluding an allocation of selling expenses to mining processes in the fully integrated industry, we submit that the Regulations must be held invalid. In particular, Treas. Reg. §1.613-4(d)(4)(iii) specifically permits the allocation of expenses which are not directly identifiable with either a mining or nonmining operation. Examples of such costs are general overhead expenditures and selling expenses.[14] With respect to the former type of expense, Treas. Reg. §1.613-4(d)(4)(iii) permits an allocation between mining and nonmining on a reasonable basis, without regard to whether the producer is in a fully integrated industry. Any interpretation of the Treasury Regulations that would single out from a category of cost one particular item, *i.e.*, selling expenses, for special treatment is both arbitrary and unreasonable. Stated simply, there is no valid reason for treating selling expenses differently than the other items of cost that are not directly identifiable with either a mining or nonmining operation. If the Treasury Regulations permit an allocation on a reasonable basis for one item of expense in the category, they must likewise permit an allocation for all items of expense in the category.

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[13] *See* discussion *infra* at page 29.

[14] *Arvonia-Buckingham Slate, supra*, 426 F.2d at 486; *California Portland, supra*, 413 F.2d at 170.

Also, contrary to the Petitioner's assertion, there appear to be no cases specifically rejecting the position that a reasonable portion of selling expenses may be allocated to the cement producer's mining processes. The Court of Claims in *Standard Lime, supra,* is silent with respect to the issue of whether selling expenses are allocable between the taxpayer's mining and nonmining operations. In fact, the court was neither presented with nor did it address that specific issue. In *Mississippi Valley, supra,* 347 F. Supp. at 243, the District Court acknowledged the holding of the Ninth Circuit in *California Portland, supra,* 413 F.2d at 170, that selling expenses are properly allocated between mining and nonmining. However, without stating that it was refusing to follow *California Portland,* the District Court held that the expenses of selling were all nonmining costs, apparently because such selling expenses were incurred by the taxpayer's *agent,* rather than the taxpayer. The Petitioner also refers to the statement by the Tenth Circuit in *Ideal Basic, supra,* 404 F.2d at 126, that selling expenses are nonmining costs. However, reliance by the Petitioner on *Ideal Basic* seems misplaced, because, as stated previously, the Tenth Circuit specifically excluded selling expenses entirely from the formula.

A review of the court decisions that do address the issue of the proper treatment of selling expenses in the proportionate profits formula reveals that such costs are partially allocable to the integrated miner-manufacturer's mining operation. In particular, in *California Portland, supra,* 413 F.2d at 170, the Ninth Circuit found that a cement producer's selling expenses were not direct costs identifiable with either the mining or manufacturing phase, but rather were incurred for the benefit of the entire operation. The court concluded that the selling expenses could be allocated in the proportion that mining costs

bore to the total costs. *Accord, Southwestern Portland Cement, supra,* 435 F.2d at 508. The Fourth Circuit reached a similar conclusion in *Arvonia-Buckingham Slate, supra,* 426 F.2d at 486. Of particular interest in the latter case is the Fourth Circuit's comment that common knowledge reveals that selling expenses benefit both mining and nonmining activities. Thus, the court concluded that selling expenses, like general overhead expenditures, are not directly identifiable with either a particular mining or nonmining process, and were, therefore, to be allocated in the proportion that the mining costs bore to the total costs.

For the foregoing reasons, it is submitted that the Treasury Regulations should be interpreted to provide an allocation of selling expenses of an integrated miner-manufacturer of cement between mining and nonmining, based on a reasonable method. If, however, the Treasury Regulations are interpreted to require a different result, the Regulations should be held invalid.

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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APPENDIX A

This example compares an integrated miner-manufacturer in an industry where a representative market price exists for the mineral before the application of nonmining processes and an integrated miner-manufacturer in an industry required to use the proportionate profits formula. Assume that both integrated miner-manufacturers sold one ton of their respective products and that each had the following results of operation:

Representative Market Price:

Gross Sales:	$200	per ton bulk product
Representative Market Price:	$100	per ton bulk product
Manufacturing Cost:	$ 20	per ton
Mining Cost:	$ 20	per ton
Bagging Cost:	$ 30	per ton
Bagging Premium:	$ 30	per ton

Proportionate Profits Method:

Gross Sales:	$200	per ton bulk product
Mining Cost:	$ 20	per ton
Manufacturing Cost:	$ 20	per ton
Bagging Cost:	$ 30	per ton
Bagging Premium:	$ 30	per ton

Considering first the situation where the product was sold in bulk form only, each producer's gross income from mining would be $100, which is computed as follows:

Representative Market Price:

Gross Income From Mining = $100 Representative Market Price

Proportionate Profits Method:

$$\frac{\text{\$20 Mining Cost}}{\text{\$40 Total Mining and Manufacturing Cost}} \times \text{\$200 Gross Sales} = \text{\$100 Gross Income From Mining}$$

However, if the product is sold in bags, and the bagging costs are treated as suggested by the Petitioner, the proportionate profits method yields a gross income from mining equal to $65.71, and the representative market price still yields a gross income from mining equal to $100.00, which amounts are calculated as follows:

Representative Market Price:

Gross Income From Mining = $100 Gross Sales

Proportionate Profits Method:

$$\frac{\text{\$20 Mining Cost}}{\text{\$70 Total Cost}} \times \text{\$230 Gross Sales} = \text{\$65.71 Gross Income From Mining}$$

The difference between the gross income from mining computed under the proportionate profits method ($65.71), and the gross income from mining computed per the representative market price ($100), is the result of the fact that, in the proportionate profits method, the bagging costs are deemed to earn not only a portion of the bagging premium, but also a portion of the constructive sales price of the first marketable product.

APPENDIX B

Assume that the integrated miner-manufacturer's results of operation are as follows:

		Sales Price
Two Tons of Cement were Sold:		
One Ton was sold in bulk		$150
One Ton was sold in bagged form:		
Bulk Price	$150	
Bag Premium	10	160
Total Sales Price		$310

	Costs
Mining Cost ($25 per ton)	$50
Manufacturing Cost ($12.50 per ton)	25
Bagging Cost ($15 per ton)	15
Total Cost	$90

In the Petitioner's proportionate profits fraction applicable to that illustration, the numerator would consist of mining cost of $50 and the denominator would consist of mining, manufacturing and bagging costs of $90. The fraction so constructed (*i.e.*, 50/90) would then be multiplied by the producer's *actual sales of bulk and bagged cement* (*i.e.*, $310) and is illustrated thus:

$$\frac{\$50 \text{ Mining Cost}}{\$90 \text{ Total Cost}} \times \$310 \text{ Gross Sales} = \$172.22 \text{ Gross Income From Mining}$$

More specifically, the *same* fraction (50/90) would be multiplied by the producer's sales price of bulk cement ($150) *and* bagged cement ($160):

$$\frac{\$50 \text{ Mining Cost}}{\$90 \text{ Total Cost}} \times \$150 \text{ Gross Sales Bulk} = \$83.33 \text{ Gross Income From Mining}$$

and:

$$\frac{\$50 \text{ Mining Cost}}{\$90 \text{ Total Cost}} \times \$160 \text{ Gross Sales Bagged} = \$88.89 \text{ Gross Income From Mining}$$

Total Gross Income From Mining: $172.22

In the terms of the assumption on which the equation is based, every dollar of mining cost in the example earns 55% (*i.e.*, 50/90) of every dollar of income, regardless of whether the income results from a sale of bulk cement or bagged cement. Every dollar of mining cost in the producer's operations did not produce 55% of each dollar of income, however. Rather, with respect to the cement sold in bulk form, every dollar of mining cost earned *66%*, not 55%, of every dollar of income.

In the proportionate profits fraction, as the Respondent argues it should be applied to the sale of bulk cement, the numerator would consist of mining cost of $50 and the denominator would consist of mining and manufacturing costs of $75. The fraction so constructed (*i.e.*, 50/75) would then be multiplied by the producer's actual sale of bulk cement (*i.e.*, $150) and is illustrated thus:

$$\frac{\$50 \text{ Mining Cost}}{\$75 \text{ Total Cost}} \times \$150 \text{ Gross Sales Bulk} = \$100 \text{ Gross Income From Mining}$$

The fraction applied to the gross sales price of the bagged cement would consist of a numerator of $25 (mining cost) and a denominator of $52.50 (mining, manufacturing, and bagging cost) and would be applied thus:

$$\frac{\$25 \text{ Mining Cost}}{\$52.50 \text{ Total Cost}} \times \$160 \text{ Gross Sales Bagged} = \$76.19 \text{ Gross Income From Mining}$$

In the bagged sale, every dollar of mining cost earns 47.6% of every dollar of income. The critical fact, however, is that by applying the two different fractions to their respective gross sales amounts (*i.e.*, bulk and bag), the producer has gross income from mining equal to $176.19, which is $3.97 more than the gross income from mining derived under the Petitioner's application of the proportionate profits formula. More specifically, the weighted average of the two fractions is 56.8% [(66% + 47.6%) ÷ 2], which is greater than the 55% derived by the Petitioner's application of the formula.